200433

MAYER, BROWN & PLATT

1909 K STREET. N.W

WASHINGTON. D.C 20006-1101

ERIKA Z. JONES
DIRECT DIAL (202) 263 3232
ejones@mayerbrown.com

MAIN TELEPHONE
202-263-3000
MAIN FAX
202-263-3300

November 17, 2000

The Honorable Vernon A. Williams
Secretary
The Surface Transportation Board
1925 K Street, N.W.
Washington, D.C. 20423-0001

Re: Ex Parte No. 582 (Sub-No. 1), Major Rail Consolidation Procedures

Dear Secretary Williams:

Enclosed for filing in the above-captioned proceeding are the original and twenty-five (25) copies of the Comments of The Burlington Northern and Santa Fe Railway Company, including the verified statements of Robert D. Krebs, Professors José A. Gómez-Ibáñez and Joseph P. Kalt. Professor Richard J. Pierce, Jr., and Professor Bradford Cornell. Also enclosed is a 3.5 inch disk, containing the text of the Comments in WordPerfect 9 format.

I would appreciate it if you would date-stamp the enclosed extra copy of the Comments and return it to the messenger for our files.

Sincerely,

Erika Z. Jones

Erika Z. Jones

Enclosures

cc: All Parties of Record

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BEFORE THE
SURFACE TRANSPORTATION BOARD

EX PARTE NO. 582 (SUB-NO. 1)

MAJOR RAIL CONSOLIDATION PROCEDURES

COMMENTS OF THE BURLINGTON NORTHERN
AND SANTA FE RAILWAY COMPANY

Jeffrey R. Moreland
Richard E. Weicher
Michael E. Roper
Sidney L. Strickland, Jr.
The Burlington Northern and
Santa Fe Railway Company
2500 Lou Menk Drive
Fort Worth, Texas 76131-0039
(817) 352-2368

Erika Z. Jones
David I. Bloom
Robert M. Jenkins III
Adrian L. Steel, Jr.
Roy T. Englert, Jr.
Mayer, Brown & Platt
1909 K Street, N.W.
Washington, D.C. 20006-1101
(202) 263-3000

Attorneys for The Burlington Northern and Santa Fe Railway Company

November 17, 2000

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MAJOR RAIL CONSOLIDATION PROCEDURES

COMMENTS OF THE BURLING... ORTHERN
AND SANTA FE RAILW... NY

The Burlington Northern and Santa Fe Railway Company ("BNSF") hereby files its comments, including the verified statements of Robert D. Krebs, Professors José A. Gómez-Ibáñez and Joseph P. Kalt, Professor Richard J. Pierce, Jr., and Professor Bradford Cornell, in response to the "Notice of Proposed Rulemaking" ("NPR") issued by the Surface Transportation Board ("Board") on October 3, 2000. In the NPR, the Board has requested comments on proposed changes in its merger rules that would significantly raise the bar for future mergers of Class I railroads.

I. EXECUTIVE SUMMARY

BNSF supports those narrow changes proposed by the NPR that would refine the Board's current pro-merger policy to address the precise concerns raised by recent mergers. Specifically, BNSF supports the requirements that future merger applications include (i) detailed service assurance plans, and (ii) proposals for maintaining competition through an open major gateway policy and the preservation of the "contract exception" right for shippers affected by a merger.

However, BNSF strongly opposes the unduly prolonged schedule proposed by the Board for handling Class I railroad mergers, which could stretch to 19 months or longer.

Such a schedule is not consistent with the demands of the economy in general or of shippers, other carriers and ports. It could adversely affect the access of railroads to capital markets, reduce the benefits generated by rail mergers, and place merger applicants in a state of regulatory limbo that would be harmful to shippers and the railroad industry. Therefore, BNSF proposes herein a maximum review period of one year from the date of the pre-filing notification. Moreover, given the end-to-end nature of likely future Class I transactions, there is no reason why the Board cannot process mergers within even shorter periods, using the same simplified procedures as other agencies do in reviewing mergers of comparable scope and size, much as the Board's predecessor itself suggested in 1995.

Further, BNSF strongly opposes those provisions of the NPR that would reverse the statutory presumption in favor of mergers and require all merger applicants to propose "competitive enhancements" to offset unrelated and ill-defined presumed harms supposedly arising from irremediable reductions in geographic and product competition and unavoidable transitional service problems. BNSF also believes that the Board must carefully limit the categories of "downstream" and "crossover" effects it will review in merger cases to those that are sufficiently concrete to be suitable for analysis and are related directly to the actual merger pending before the Board. Furthermore, the Board's oversight of a consummated merger should be limited to policing the efficacy of competitive remedies adopted in that merger proceeding and addressing merger-related service problems. The Board should not penalize a merged railroad, or impose new conditions on a merger, merely because all projected benefits of the merger are not realized on schedule or because a future merger produces some new, unanticipated harm.

Taken together, the provisions of the NPR opposed by BNSF would impose unacceptable delay in merger review, remove predictability and finality from Board review of mergers, and signal a return by the Board to discredited interventionist policies that would result in significant harm to the rail industry and to rail shippers. As a result, the NPR could prevent the proposal or consummation of beneficial mergers and encourage the flight of capital from the rail industry at precisely the time when the industry must invest to expand its capacity and improve its competitive position and services.

Therefore, in any final rule, the Board should: (i) adopt procedural rules that will result in final Board action no later than one year after the pre-filing notification of a merger; (ii) require merger applicants to submit a detailed service assurance plan and proposals (such as open gateways, contract exception rights, and protection for 2-to-1 shippers) that would preserve effective competitive alternatives for those shippers who now have them; (iii) eliminate the presumption that mergers can no longer produce significant public benefits; (iv) eliminate the presumption that future mergers will cause competitive or service harms that must be offset by unrelated competitive enhancements; (v) limit the scope of Board review of downstream and crossover effects; and (vi) avoid post-merger review of issues other than the efficacy of competitive remedies adopted as conditions of the merger and the need for temporary remedies for any merger-related service failures.

If so revised, the final rules would protect shippers against the repetition of past service problems and preserve effective competitive rail options, while still giving railroads the tools and ability to attract the capital necessary to meet the service and competitive challenges of the new century. Such rules also would provide the timely, predictable and final action that capital markets, railroads, shippers and other interested parties require.

II. INTRODUCTION

The U.S. rail industry has made significant progress in the last twenty years, rationalizing capacity, increasing productivity and decreasing real rates for shippers. Mergers have been a critical tool in attaining these benefits for the Nation.

The rail industry now faces different problems from those of the past. Although a primary focus of mergers once was the elimination of excess capacity, many industry participants agree that the industry now requires new capacity, new services and improved efficiency in order to meet the requirements of its customers and respond to pressures from competitors.

To meet the needs of the industry and its customers, railroads must have the ability to move quickly. However, the proposed rules would impose a lengthy procedural schedule that is incompatible with the requirements of today's economy, particularly those of capital markets. In contrast, mergers of major companies in other industries, including regulated industries, routinely are reviewed by other government agencies in a matter of months. *See* Attachment 2 to these comments. A prolonged schedule for rail mergers would impose unnecessary direct and indirect costs on merging railroads, shippers, other carriers and ports. An extended procedural schedule would expand the uncertainty that capital markets abhor, deny shippers the timely benefits of rail mergers, and limit the ability of railroads and shippers to respond to changed circumstances and new opportunities during the review period. By deferring merger benefits and creating uncertainty, the unnecessarily protracted proposed schedule for handling merger applications could, in and of itself, result in a "good" merger becoming a "bad" merger. This would be unsound and destructive public policy.[1] The Board, therefore, should complete its review of future merger applications no later than one year after the filing of the pre-filing notification.

The Board's merger policy should continue to favor mergers because mergers can still produce public benefits. Mergers can help the rail industry quickly, inexpensively and effectively expand capacity through the more efficient use of existing capital assets. Mergers also can enable railroads to reduce their costs. They can encourage new investment, as evidenced by the investments triggered by recent mergers in the industry, and enable enhanced services to be offered to shippers. By expanding the scope of networks, mergers can help railroads meet a greater range of shippers transportation needs, thereby attracting new business and improving their overall competitive position in the national transportation market. The ability to pursue mergers, when warranted, can reassure investors about the future of a rail industry that today is not earning its cost of capital. Accordingly, both public policy and a clear Congressional mandate require that the Board continue to favor and approve efficiency-producing mergers.

However, by creating unfounded substantive and procedural obstacles to future mergers, the proposed rules would deepen the capital problems of the rail industry and impede railroads' efforts to create new capacity and improve their competitive positions. Adoption of the proposed rules also would raise fears that the Board is returning to the intrusive and failed policies of the past. While merger applicants today understand what issues they must address when contemplating and then pursuing a merger, the proposed

1 "Markets do not stand still while the Board is deliberating. The longer the Board takes, the longer the merging parties are caught in limbo. Investors and stockholders are well aware of the adverse effects [illegible] can have on profitability, and their perception of the risk will be reflected both in the value of the railroad's stock and in their decisions to invest in the industry." Verified Statement of Bradford Cornell ("V.S. Cornell") at 10.

rules would remove the essential element of predictability required for sound business planning and regulatory policy. Furthermore, because the Board's proposed rules contemplate the imposition of additional conditions during an extended oversight period and require merged railroads to guarantee projected benefits, the parties will lack the finality, closure and certainty the regulatory process should provide.[2]

Key elements of the proposed merger rules are based on unsound economic analysis and regulatory policy, and are contrary to law. For example, even though the proposed rules would create new requirements (the maintenance of open major gateways and contract exception rights) that supplement the Board's traditional approach to competitive issues, the rules would presume, perhaps irrebuttably, that competitive harms would be produced by any future merger of Class I railroads. This presumption cannot be justified. The Board has adequate tools to define and then address with narrowly crafted remedies the actual extent of competitive harms that might be produced by any specific merger proposal, particularly with respect to the end-to-end mergers of the future. Furthermore, even under its proposed rules, the Board would have to engage in a detailed analysis of the presumed competitive harms in order to determine what level of competitive enhancements would be required to offset those presumed harms.

Even though the proposed merger rules would require the submission of extremely detailed service assurance and transition plans and provide for extensive post-approval

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2 "Investors have choices. If the long-term prospects of the railroad industry are significantly clouded by regulatory restrictions and regulatory uncertainty, investors will be reluctant to risk their funds in the industry. This, in turn, may reduce the industry's access to funds in the capital markets and raises their cost of capital. This higher cost of capital translates into a reduced stock price, which hurts the firm's shareholders and further discourages new investment." V.S. Cornell at 9.

operational monitoring by the Board, the NPR presumes that significant transitional service problems will nevertheless accompany all future mergers. In so doing, the NPR does not properly recognize that the unique transitional service problems of the UP/SP and CSX/NS/Conrail transactions are unlikely to be repeated. UP acquired a railroad that had underinvested for years, and CSX and NS divided an existing carrier's assets in a manner unprecedented in the past and unlikely to be repeated in the future. The NPR also does not recognize that the end-to-end mergers of the future are far less likely to raise significant service issues. Finally, railroads face powerful financial incentives not to repeat past service problems, which led to sharply reduced earnings, litigation, and damaged relations with customers.

The proposed rules also underestimate or, perhaps, do not value at all the intermodal competition that mergers produce, the evidence that intramodal competition has remained strong after prior mergers (as demonstrated by real rate reductions for all classes of shippers), and the investments that merged railroads have made in improving service and hence their competitive positions. Moreover, the NPR would require the Board to speculate whether the benefits projected for a specific merger could be replicated through an alliance or joint marketing effort that no one has actually proposed.[3] However, given the

[3] "It would be irrational for two railroads to propose an end-to-end merger unless they believed that the merger would generate cost savings and service improvements that they could not gain by other means. The cost, delay, and uncertainty of the merger process give railroads strong incentives to seek their ends by other means. The fact that railroads continue to pursue end-to-end mergers is thus strong evidence that mergers can provide benefits that are unavailable via other types of transactions. Railroads' preference in many cases to achieve integration through merger rather than alternative contractual arrangements is driven by the underlying economics of the rail industry. In order to move traffic from origin to destination while meeting the service needs of shippers, railroads must solve a technical coordination problem. Railroads allocate resources and coordinate decision-making regarding scheduling, routing, allocating locomotives, prioritizing car

additional costs of a merger, including the substantial expense of preparing the environmental review and the risk that unacceptable competitive and service conditions will be imposed or the merger rejected, the Board can assume that merger applicants have reviewed their alternatives thoroughly before subjecting themselves to the merger review process.

By presuming harms that have not been shown to be either likely or significant and then requiring merger applicants to offset these hypothetical harms with unrelated competitive enhancements, the proposed rules would make it impossible for future merger applicants reasonably to forecast Board action. Furthermore, the rules would encourage interested parties to seek "rents" by demanding non-merger-related benefits, based on a claim that these benefits would compensate for the unidentified and unquantified harms caused by the merger. Because the remedies would be unrelated to the posited harms, the Board would have no predictable or reasoned basis for selecting among competing remedies, deciding what cumulative level of remedies is necessary, or determining which shippers should receive such windfall benefits.[4] The lack of predictability would impede

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switching, moving trains through congested yards, etc. These decisions interact in ways that can affect numerous portions of a railroad's operations and the shippers who use that system. As a result, railroads establish complex operations, procedures, and protocols that attempt to balance the needs of all of their shippers, and rail managers are constantly deciding in real time which trains should have priority and what actions to take when unplanned contingencies occur." Verified Statement of José Gómez-Ibáñez and Joseph P. Kalt ("V.S. Gómez-Ibáñez/Kalt") at 23.

[4] "In the absence of a clear standard, it will be difficult [for the Board] to limit or constrain the requests for favors and difficult to prevent arbitrary outcomes based on the success of shippers' bargaining." V.S. Gómez-Ibáñez/Kalt at 18. "The unfairness inherent in providing benefits to one class of shippers, rather than another, is a key reason why remedies should be designed to offset specific harms to specific groups." Verified Statement of Richard J. Pierce, Jr. ("V.S. Pierce") at 17.

beneficial change and harm the ability of the rail industry to raise necessary capital, and therefore is strongly undesirable from a public policy perspective.[5]

The NPR's proposal on the analysis of "crossover" and "downstream" effects also is far too broad. Merging railroads should be required to demonstrate that their merger will not produce adverse crossover effects by creating service problems for other railroads.[6] However, with respect to downstream effects, it would be speculative for any merger applicant to forecast the actions of its competitors. Such speculation would invite meaningless debate and abuse of the merger review process, as competitors and other interested parties posit downstream responses that somehow require the rejection or conditioning of the merger actually before the Board.[7] Furthermore, it would be inappropriate policy and contrary to the statute to remedy competitive or other problems arising from a potential (or a future) merger with new conditions on an already

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[5] "[B]y adopting a presumption that future mergers are inherently harmful and making it more difficult to justify future mergers, the proposed new merger policy signals investors that the Board is satisfied with the status quo of rail sector financial performance and capital investment." Verified Statement of Robert D. Krebs ("V.S. Krebs") at 3.

[6] "While a railroad has the clear economic incentive to prevent disruption of its own system, it can rationally ignore the effects of its disruptions on *other* railroads' service, revenue, and profits. . . . Of course, the foregoing does not mean that merging railroads will always under-protect against service disruption. Recent mergers, such as those between BN and the ATSF and the Canadian National/Illinois Central transactions, provide counterexamples that make it clear that the generalized disruption of the rail network is not an inevitable consequence of mergers. It is clear that the presence of service disruption is directly related to the method by which a merger is implemented. . . . [and] the Board has a legitimate role in protecting the public against merger-related service disruptions." V.S. Gómez-Ibáñez/Kalt at 13.

[7] "[P]roposed mergers should not be impeded by a proposal that imposes substantial new burdens on applicants, elevates speculation to the role of evidence, and opens a Pandora's box of political pressures and temptations while adding nothing of value to the merger review process." V.S. Gómez-Ibáñez/Kalt at 29.

consummated merger. Therefore, the middle ground proposed by BNSF in response to the ANPR remains the only feasible proposal – if a second rail merger is announced and notice of it is filed with the Securities and Exchange Commission ("SEC") by the date that initial comments are due with respect to the first merger, the parties to the first merger proceeding should address whether any new competitive problems would be created by the two mergers.

Finally, the Board should limit its post-merger oversight to a review of whether the conditions imposed to maintain shippers' competitive options have worked; whether service assurance plans have been followed and updated to maintain service integrity for rail shippers, shortlines and regional carriers and ports; and whether temporary remedies are required to alleviate any temporary merger-related service problems that may have developed. A merged railroad should not be subject to the post-merger imposition of conditions in response to unforeseen circumstances or a future merger.[8] Further, a merged railroad cannot be the guarantor of merger benefits in today's dynamic economy. Indeed, such a policy would encourage a merged railroad to make bad decisions – such as laying off employees, making unnecessary capital investments, or rushing implementation instead of proceeding with step-by-step caution – only to satisfy the post-merger review. Moreover, a merged railroad might not achieve all projected benefits precisely because the merger triggered competitive responses by intra- and intermodal competitors. Thus, it is not clear how the Board could – or why it should – unscramble a merger or impose significant new

[8] "I cannot imagine any firm that would be willing to merge, or even to consider a merger, under conditions in which an agency can impose unknown and unknowable conditions on the merged firm years after the merger is approved and implemented." V.S. Pierce at 20.

conditions if all projected benefits were not achieved on precisely the schedule originally forecast.

If the proposed rules are adopted without significant changes, good mergers – those that create public and private benefits, maintain effective competitive options for shippers who now have them, preserve and improve the quality of service, and create the efficiencies and attract the new traffic necessary to justify further investment in the rail industry – would be discouraged, if not prohibited. Indeed, good mergers may not even be proposed because railroads may conclude that the procedural and substantive bars to mergers have been raised too high to be satisfied at a fair cost. Even if the rules do not discourage railroads from initiating mergers, the policy could result in the rejection of a good merger without any showing that the merger would produce an irremediable concrete harm. This is not sound economic or regulatory policy; it is bad law, and it would undermine the progress of the last two decades.

Regulators across the United States and around the world have recognized that regulation should be crafted as narrowly as possible, aimed at only those issues that cannot be better handled through competition in the marketplace. In particular, there is broad consensus among economists, regulators and legislators that merger policy should focus on the specific competitive effects of a proposed merger.[9] Therefore, absent

[9] "[I]n non-regulated industries, where the harm to competition and the risk of the exercise of market power is the primary focus of merger policy." V.S. Gómez-Ibáñez/Kalt at 4 (citing Horizontal Merger Guidelines, U.S. Dept. of Justice and Federal Trade Commission, April 12, 1997, as amended April 18, 1997). Even regulated industries have moved in this direction. For example, the Federal Energy Regulatory Commission ("FERC") has streamlined its merger approval process over time to focus almost exclusively on the effects on competition. V.S. Pierce at 7-11 (describing FERC's regulatory procedures).

significant irremediable effects, market-driven mergers should be permitted to go forward. Merger policy should not encourage unaffected parties to seek rents or conditions unrelated to the merger, nor should it be used as a blunt instrument for regulators to force the restructuring of an entire industry. Merger policy should defer to market forces except when identified competitive and service harms are threatened. Merger policy should recognize the high costs of regulatory delay and the need to provide industry participants with clear guidance that can be used reasonably to project regulatory outcomes.

Until the start of the Ex Parte No. 582 process, the Board seemed committed to the same kind of market-driven merger policies that guide other U.S. antitrust and regulatory authorities. Yet by expanding the scope of Board review and increasing the uncertainty of Board actions, the NPR would move the Board in the opposite direction from general regulatory policy in the United States. This would lead to underinvestment in the railroad industry, a loss of inter- and intramodal competition, and a return to the problems of the past.

Therefore, the Board's revised merger policy statement should not disfavor mergers, but instead should maintain the pro-merger policy prescribed by Congress. The Board's merger policy should call for a balanced review, based on concrete and widely understood standards, to determine whether the proposed merger would result in the elimination of effective competitive alternatives for those shippers who currently have such alternatives or produce transitional or permanent service problems. If a merger is likely to produce public benefits, and identified competitive and service harms are avoided or appropriately mitigated, the Board's merger policy should result in the timely review and approval of that merger – without injecting presumptions of harms, the need to counterbalance such hypothetical harms with unrelated competitive enhancements, or the ability of third parties to extract rents as the price of approval. Accordingly, the Board should adopt the focused, but meaningful, changes in its merger policies proposed by BNSF in response to the ANPR, accelerate its review of rail mergers so that all mergers are reviewed within one year of the pre-filing notification, and otherwise leave intact its current general approach to rail mergers.

III. DISCUSSION

A. It Is Vital That Merger Proceedings Be Handled Expeditiously, Within Periods Consistent with the Requirements of the Economy and Capital Markets. The NPR proposed that evidentiary proceedings be completed within one year after an application is filed, with a Board decision to be issued within 90 days after closure of the evidentiary proceeding. Proposed 49 C.F.R. § 1180.4(e), NPR at 27. With a prefiling period of 90 to 180 days, this could result in merger reviews taking almost 2 years to complete, a period that is simply too long given the financial realities of today's economy. The deadline for Board action on a merger application should be reduced to a maximum of one year, including the pre-filing period and a six-month period for any required evidentiary proceedings.

The unwarranted regulatory delay proposed by the NPR would create significant harm for the rail industry and shippers. In his Verified Statement, Robert Krebs states that:

> First, there is no reason to delay the benefits of a good merger for shippers. Yet, extended procedural schedules defer those benefits for shippers and can even lead to the complete loss of those benefits because good mergers are either not proposed or are undone by the delay and uncertainty of the review process. Second, during the period when a merger is pending before the Board, the applicants and other parties are placed in a regulatory limbo, unsure how to plan for the future or how to respond to other opportunities.

> Regulatory limitations on a railroad's use of its assets and uncertainty about future limitations act not only as disincentives for the railroads to invest in particular projects but also as disincentives for outside investors to invest in the railroad . . . . Investors have choices. If the long-term prospects of the rail industry are significantly clouded by regulatory restrictions, investors will be reluctant to risk their funds in the industry. This, in turn, may reduce the industry's access to funds in the capital markets and raises their cost of capital. V.S. Cornell at 8-9.

Professor Cornell further explains that:

> Each of these regulatory taxes diminishes the prospective benefits of possible merger transactions. It is quite conceivable that a merger that otherwise promised to make the merging railroads more efficient, improve their services, and help them cover their cost of capital – with no unremedied competitive harms – would effectively be defeated by such taxes. That is not in the railroads' interest, it is not in their customers' interest, and it is not in the public interest. *Id.* at 13.

The BN/SF and UP/SP mergers demonstrated the positive benefits that mergers can produce. In both cases, competitive options were retained for those shippers who had such options prior to the mergers. Post-merger, BNSF and UP made significant investments in infrastructure improvements, new locomotives, and additional or advanced rolling stock. Both BNSF and UP offered new services to their shippers, including efficient and competitive services that finally delivered the unfulfilled promises of earlier joint ventures. The Board should not turn its back on the benefits that future mergers can produce, such as the benefits that the proposed combination of BNSF and CN would have produced. V.S. Krebs at 7 - 8.

Furthermore, any "paradigm shift" in the current pro-merger policy reflected in the Board's current regulations must come from Congress. Congress established the pro-merger statutory policy, and only Congress can reverse that policy. Even if the proposed rules did not incorporate an overt anti-merger bias, but rather only adopted a neutral stance hypothetical harms with unrelated competitive enhancements, or the ability of third parties to extract rents as the price of approval. Accordingly, the Board should adopt the focused, but meaningful, changes in its merger policies proposed by BNSF in response to the ANPR, accelerate its review of rail mergers so that all mergers are reviewed within one year of the pre-filing notification, and otherwise leave intact its current general approach to rail mergers.

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> Third, capital markets cannot tolerate uncertainty or delay. The mere threat of an extended regulatory proceeding would cause capital to seek other investment opportunities and place downward pressure on railroad stocks. V.S. Krebs at 3-4.[10]

In the rail industry, capital markets see a review process that takes much longer than that of other industries. The markets also remember that the Board already has imposed an effective 34-month moratorium[11] on rail mergers, ostensibly so that it could more effectively – not in a more cumbersome way – process merger applications. Finally, as the Board has implicitly recognized in its proposal to discount future benefits, there is a time value of money, so the length of the review process can, by delaying the realization of merger benefits, turn a "good" merger into a "bad" merger or lead railroads to choose not to pursue good mergers.

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10 Robert Krebs further states that "[T]he bottom line is that shareholders and shippers alike suffer when they must defer enjoyment of the benefits accruing from a beneficial rail merger until the conclusion of the lengthy STB review process." V.S. Krebs at 6. This position is supported by Professor Cornell in his verified statement, where he states "[d]elay in the approval process is particularly insidious from a financial standpoint. Not only does it delay the cash benefits of the merger, thereby significantly reducing the present value of the transaction, but it prevents the railroads that plan to merge from determining their optimal capital expenditure levels and allocation of assets while they are enmeshed in regulatory limbo." V.S. Cornell at 4.

Professor Cornell further explains that "[A] 19-month delay imposes a serious tax on the finances of any combination. In effect, it would set back by nearly two years the merging railroads' ability to begin to realize the benefits of the transaction. Moreover, it would make it impossible during that time period for either of the merging parties to determine their optimal capital expenditure levels and allocation of assets. . . . Investors and stockholders are well aware of the adverse effect this can have on profitability, and their perception of the risk will be reflected in both the value of the railroads' stock and in their decisions to invest in the industry." V.S. Cornell at 10.

11 On March 17, 2000, the Board announced a moratorium on the filing of merger applications until its new merger rules are issued in June 2001. Because any future merger would be subject to at least a 3-month pre-filing notification period and the proposed 16-month review period, the result would be an effective moratorium of 34 months.

There is no reason for merger review to take as long as the NPR proposes. Given the additional detailed information that the NPR would require to be part of any application, the express requirement that many procedural and case management issues be handled during the pre-filing period, and the end-to-end nature of the mergers likely to be proposed in the future, any final rule adopted by the Board should significantly <u>accelerate</u> the merger review process.

BNSF has reviewed the time taken for mergers to be processed in both regulated and unregulated industries; the results are shown in Attachment 2 to these comments. Of 48 mergers of large corporations that were subject to review by the Federal Trade Commission ("FTC") or the Department of Justice ("DOJ"), including large telecommunications mergers in which the Federal Communications Commission had a significant role, 34 were resolved in six months or less. Similarly, between 1995 and the present, the Federal Energy Regulatory Commission ("FERC") was able to resolve 29 of 49 merger proposals in less than six months, including several mergers that created new utility giants.[12] FERC was able to improve its merger processing time significantly when it narrowed the scope of its merger review and defined more precisely for applicants what issues must be addressed in any application. FERC also has been able to process most mergers without the need to supplement the initial filings of the parties with third-party discovery, depositions or other evidentiary proceedings. The Board should do the same.[13]

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[12] *See* V.S. Pierce at 7-11 for a discussion of FERC procedures.

[13] Even if the Board determines that discovery is required, the Interstate Commerce Commission showed in the BN/SF merger proceeding that the merger review process can be completed in less than one year. In that proceeding, the applicants' notice of intent was filed on July 8, 1994. The proceeding was suspended for a period of 3 months from December 5, 1994, to March 9, 1995. The Commission's final decision was issued on

Furthermore, the mere size of a merger should not dictate the time it takes to analyze the merger. In fact, large mergers that do not raise difficult competitive issues often are handled by DOJ/FTC and other agencies in only a few months. Many agencies are able to process mergers without significant evidentiary proceedings, relying instead on paper hearings without discovery. The Board should adopt this approach, so that rail mergers that do not raise competitive or other complicated issues are handled on an expedited basis.

For these reasons, BNSF requests that the Board adopt the procedural schedule for Class I mergers set forth in Attachment 1. This schedule would result in final Board action on merger applications within 270 days of the filing of a complete merger application, or approximately one year from the date that the pre-filing notification is submitted to the Board. This schedule is closer to the timetables for final review in other industries with which the rail sector competes for capital and, equally important, this schedule is consistent with schedules that the Board's predecessor itself has stated are ample to ensure full review of a merger application.

In a notice of proposed rulemaking, the Interstate Commerce Commission proposed to complete its merger proceedings within 180 days after the filing of a Class I merger application. Ex Parte No. 282 (Sub-No. 19), New Procedures in Rail Acquisitions, Mergers and Consolidations (served January 26, 1995). The Commission concluded that such a time frame would fully preserve the opportunity for effective participation by affected persons and the public at large, would provide for reasoned consideration of the arguments

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August 23, 1995. The proceeding thus encompassed 10 months, excluding the period of suspension.

for and against a proposed application, and would permit consideration of competing applications, proposed conditions and amendments offered by the applicants to meet objections to a proposed transaction.[14] The schedule proposed by BNSF would do likewise and, in fact, would add 90 days to the Commission's 1995 proposed schedule.

A review period of one year for Class I mergers also would accommodate the environmental review required under the National Environmental Policy Act ("NEPA") and the Board's existing environmental regulations. The Board, in cooperation with the applicants, could initiate many of the steps involved in the NEPA process as soon as applicants filed the pre-filing notification, instead of waiting for the filing of the application. These steps could include publication in the Federal Register of the notice of intent to prepare an Environmental Impact Statement ("EIS") (should the decision be made that an EIS is required), selection of the third party contractor, coordination with other federal and state agencies, and initiation of the scoping process.

Even if the Board were to decide not to initiate one or more of these steps in a given proceeding until after an application was filed, BNSF's proposed procedural schedule still provides ample time for completion of the environmental review in advance of final action by the Board. For example, under BNSF's proposed schedule, the notice of intent to prepare an EIS and request for comments on the scope of the EIS would be issued 7 days

[14] In fact, a variant of the Commission's proposed 180-day schedule was applied to the then pending BN/SF merger proceeding, and, excluding the period when the proceeding was suspended, the Commission completed the evidentiary portion of the proceeding in approximately 6 months. *See* Burlington Northern Inc., et al. – Control and Merger – Santa Fe Pacific Corp., et al., Finance Docket No. 32549, Decision No. 10 (ICC March 7, 1995). The time allotted for briefing, oral argument and the Commission's decision was substantially less than BNSF has proposed here, and the Commission was nonetheless fully able to review the issues raised by the proposed merger, identify necessary conditions, and complete the environmental review process.

after the filing of the application, and the final notice concerning the scope of an EIS would be issued 45 days after the filing of the application. A Draft EIS would be published 110 days after the application was filed,[15] with comments on the Draft EIS due 155 days after the application was filed. The Final EIS would be issued 205 days after the application was filed, making it available to the Board 5 days in advance of oral argument and 15 days before the voting conference.

BNSF's proposed environmental schedule is not significantly shorter than those adopted by the Board in recent rail merger proceedings[16] and would clearly meet the key time periods established under the Council of Environmental Quality NEPA requirements for conducting an EIS. They require that the comment period on the Draft EIS be a minimum of 45 days and that the final agency action cannot occur sooner than 90 days after the Draft EIS or 30 days after the Final EIS. 40 C.F.R. § 1506.10.

Therefore, the Board should adopt a procedural schedule that requires review of a proposed merger to be completed within one year of the pre-filing notification. Such a

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[15] To facilitate a timely environmental review process, parties contemplating the filing of inconsistent or responsive applications should be required to file any responsive environmental reports 20 days prior to the filing of such applications (or 70 days after filing of the primary application), unless the responsive applicant can certify that the transaction proposed in such responsive application would fall within the exception criteria of 49 C.F.R. § 1105.6 (c)(2).

[16] In all of the recent merger cases, with the exception of the Conrail acquisition, an Environmental Assessment was completed within 270 days. Although the EIS in Conrail was completed in slightly less than 11 months, the schedule included 45 days for the development of a Safety Integration Plan, a requirement that was established by the Board after the application was filed and therefore was not envisioned in the original environmental schedule. *See* CSX Corporation, et al. – Control and Operating Leases/Agreement – Conrail Inc., et al., Finance Docket No. 33388 ("Conrail"), Decision No. 89 (STB July 20, 1998) at 155.

schedule would recognize the need of all parties for timely Board action and ample time for any necessary environmental review.

B. The Presumptions Underlying the Proposed Rules Are Wrong. The NPR is premised on the view that the primary virtue of rail mergers is the elimination of excess capacity, a process the Board believes is essentially complete. *See* NPR at 10. The NPR, therefore, concludes that national policy should no longer favor mergers. Proposed 49 C.F.R. § 1180.1(a), NPR at 11. The NPR further presumes, apparently irrebuttably, that future mergers will produce competitive and service harms. *See* Proposed 49 C.F.R. § 1180.1(c), NPR at 12. As a result, the NPR requires that any merger must include "competitive enhancements" to offset these harms, effectively creating a presumption against mergers. Proposed 49 C.F.R. § 1180.1(d), NPR at 16.

Each of the NPR's premises is wrong. Furthermore, the Board lacks the authority to conclude that Congress' pro-merger policy is no longer justified and, therefore, could be reversed by the Board. Only Congress can reverse that policy.

1. There Is No Basis for the Presumption That Future Rail Mergers Will Not Produce Significant Public Benefits, and Any Such Presumption Would Violate Congressional Intent. The NPR presumes that mergers should no longer be favored because the past problem of excess capacity and the need to rationalize the rail industry have been resolved. This presumption is wrong.[17]

[17] Concerns about reducing excess capacity hardly register at all in the legislative history of the Interstate Commerce Commission Termination Act of 1995 ("ICCTA") (Pub. L. No. 104-88, 109 Stat. 803). In fact, in defending the continuation of the existing pro-merger standard, Senator Pressler barely referred to excess capacity issues at all. Instead, to the extent that excess capacity concerns figured in his position, they were subordinate to other concerns that continue to justify a pro-merger policy in the present day: "Mergers and consolidations allow the rail industry to maximize the use of its tracks, cut down on

The rail industry continues to face four significant and interrelated problems: (1) the need to add capacity; (2) the need to become more efficient in its operations; (3) the need to improve service to shippers; and (4) the need to earn a return that is adequate to attract the capital necessary to resolve the first three problems. Contrary to the assumptions of the NPR, mergers can play a crucial role in solving these problems, but only if artificial regulatory barriers to good mergers are not erected.

First, the most efficient and timely way to increase capacity is to better utilize existing assets. Mergers can expand capacity at the least possible cost. A merged railroad will have a better ability to manage its assets to maximize capacity than two railroads acting separately or through an alliance or joint venture, because it will be able to make decisions based upon the requirements of its entire network, rather than on a compromise between the competing self-interests of two allied partners.[18]

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interchange points, get the most out of switching yards, consolidate terminals, and, in short, provide better service to its customers at lower cost." 141 Cong. Rec. S17,588 (Nov. 28, 1995). Similarly, the ICC Chair, Gail McDonald, noted that the driving forces behind the anticipated future railroad mergers were the industry's desire to "become more efficient and offer 'seamless service.'" Disposition of the Railroad Authority of the Interstate Commerce Commission: Hearings before the Subcommittee on Railroads of the Committee on Transportation and Infrastructure, House of Representatives, 104th Cong., 1st Sess. 106 (1995).

[18] "The fact that railroads continue to pursue end-to-end mergers is thus strong evidence that mergers can provide benefits that are unavailable via other types of transactions." V.S. Gómez-Ibáñez/Kalt at 23.

Second, a merged railroad can be more efficient in its operations.[19] A merged railroad can combine many functions, such as information technology and accounting. A merged railroad also can achieve purchasing efficiencies that, because they require a centralized approach to asset management, can be attained only by a unified entity. A merged railroad can reduce the inputs required to achieve a given level of output, thereby producing public and private benefits. Through economies of scope and scale and the ability to make decisions based on optimizing system performance, a merged railroad can do more with less.

Third, single-line service can offer shippers more reliable service, while enabling railroads to craft new services that can attract traffic from competitors and other transportation modes. An expanded, integrated rail network can provide shippers with access to new markets. A merged railroad also can benefit from the different commodity and product expertise of the pre-merger railroads. If a merged railroad becomes a better competitor and shippers gain access to new markets and services, there will be beneficial effects for the railroad, shippers and the Nation.[20]

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19 For example, "[s]ingle-line service enhances efficiency by eliminating costs and uncertainty associated with making and managing interline movements. In addition, expansion of single-line service typically represents a dramatic improvement in the quality of service a railroad offers its shippers. As railroads expand their offerings of single-line service, they can increase the speed of their service, make service more reliable, reduce damage and loss, and reduce capital requirements by making more efficient use of rail (and shipper) facilities." V.S. Gómez-Ibáñez/Kalt at 10.

20 "The revitalization of the rail industry is one of the success stories of U.S. public policy over the last 25 years. Beginning with major regulatory reforms in the 1970s and culminating with the passage of the Staggers Act of 1980, the U.S. railroad industry has improved its performance substantially. Greater rate flexibility, deregulation of rates in certain markets, and opportunities for negotiated, tailored service offerings are among the factors that have brought railroads under the discipline of the marketplace. Regulatory reform has also allowed market forces to shape the ownership structure of railroad assets.

Fourth, a regulatory policy that continues to favor mergers will enable railroads to attract capital by reassuring investors that railroads will be free to pursue their preferred business strategies, as long as they will not eliminate competition for 2-to-1 shippers[21] or threaten shippers with service problems. Industries that depend upon capital investment in long-lived assets require the assurance that regulators will not restrict their ability to respond to market requirements unless, and then only to the extent, necessary to prevent identifiable and cognizable harms to the public interest. Capital will not be freely available to an industry in which regulators assert the right to reject one merger combination because regulators prefer a different, but unproposed outcome.

In his Verified Statement, Professor Bradford Cornell explains that:

> Limitations on a railroad's (or any other business's) use of its assets function as a tax. They reduce the assets' expected return by restricting the ways that the assets can be utilized. An investment that might otherwise have a positive net present value will not be undertaken if regulatory limitations so tax the expected stream of revenues that the value turns negative vis-a-vis the costs. The deterrent to investment is obvious when we know exactly what the regulatory limitations are, but the tax can be substantially compounded by delay and by an uncertain regulatory environment. When the amount of the regulatory tax cannot be established, railroads may choose not to make the investment at all. Alternatively, they may require a much higher return to cover the regulatory risk. Either way, the regulatory tax can kill an investment, or re-investment, that otherwise would have made good economic sense.

Increased freedom to abandon low-density, unprofitable service and to consolidate rail systems in order to exploit network economies has contributed to improvements in the industry. The result has been a dramatic improvement in the nation's rail system. While there have been bumps in the road at times, these benefits have been shared both by the nation's railroads, who have improved their financial health, and by the nation's shippers, who have access to a railroad system that is more cost-effective, can provide quality service, and has shown rates that have trended clearly downward." V.S. Gómez-Ibáñez/Kalt at 8.

[21] The effect of a merger on any 3-to-2 shippers would continue to be reviewed on a case-by-case basis.

> Regulatory limitations on a railroad's use of its assets and uncertainty about future limitations act not only as disincentives for the railroads to invest in particular projects but also as disincentives for outside investors to invest in the railroad . . . . Investors have choices. If the long-term prospects of the rail industry are significantly clouded by regulatory restrictions, investors will be reluctant to risk their funds in the industry. This, in turn, may reduce the industry's access to funds in the capital markets and raises their cost of capital. V.S. Cornell at 8-9.

Professor Cornell further explains that:

> Each of these regulatory taxes diminishes the prospective benefits of possible merger transactions. It is quite conceivable that a merger that otherwise promised to make the merging railroads more efficient, improve their services, and help them cover their cost of capital – with no unremedied competitive harms – would effectively be defeated by such taxes. That is not in the railroads' interest, it is not in their customers' interest, and it is not in the public interest. *Id.* at 13.

The BN/SF and UP/SP mergers demonstrated the positive benefits that mergers can produce. In both cases, competitive options were retained for those shippers who had such options prior to the mergers. Post-merger, BNSF and UP made significant investments in infrastructure improvements, new locomotives, and additional or advanced rolling stock. Both BNSF and UP offered new services to their shippers, including efficient and competitive services that finally delivered the unfulfilled promises of earlier joint ventures. The Board should not turn its back on the benefits that future mergers can produce, such as the benefits that the proposed combination of BNSF and CN would have produced. V.S. Krebs at 7 - 8.

Furthermore, any "paradigm shift" in the current pro-merger policy reflected in the Board's current regulations must come from Congress. Congress established the pro-merger statutory policy, and only Congress can reverse that policy. Even if the proposed rules did not incorporate an overt anti-merger bias, but rather only adopted a neutral stance toward rail mergers and increased the regulation of such mergers, the rules would be inconsistent with the Board's statutory authority.[22]

[22] If the Board actually intended to bar any future mergers, such an animus against mergers would contravene the unambiguous language of the Board's authorizing statute, as well as the clear intent of Congress. The ICCTA states that the STB "shall approve and authorize a transaction under this section when it finds the transaction is consistent with the public interest." 49 U.S.C. § 11324(c) (emphasis added); *see also* 49 U.S.C. §§ 11323-11325 (provisions relating to merger approval procedures and standards). This Congressional directive would be undermined by rules that preclude or discourage mergers that are in the public interest.

By the same token, the Board does not have the authority to institute a presumption that the benefits of mergers are outweighed by their disadvantages. The ICCTA clearly contemplates that the public interest may be served by (at least some) railroad mergers and that the relative benefits and harms of mergers are to be determined on a case-by-case basis. For instance, section 11324(b) states that:

> In a proceeding under this section * * * the Board shall consider at least * * *
>
> (1) the effect of the proposed transaction on the adequacy of transportation to the public;
>
> (2) the effect on the public interest of including, or failing to include, other rail carriers in the area involved in the proposed transaction; [and]
>
> * * * *
>
> (5) whether the proposed transaction would have an adverse effect on competition. * * * *

49 U.S.C. § 11324(b) (emphasis added). *See also id.* § 11324(c) (directing the Board to approve "a transaction" upon a finding that "the transaction" is in the public interest). These ICCTA provisions, which make clear that "each proposed transaction" is to be judged on its own merits, are inconsistent with a categorical presumption, such as the Board has proposed in its rules, that mergers are contrary to the public interest. Accordingly, the Board does not have the statutory authority to adopt rules that would preclude or discourage mergers, or that it would incorporate a presumption that mergers are contrary to the public interest.

Moreover, even if Congress had been silent on the issue of whether mergers could be precluded altogether by the Board, the Board would not have the authority to promulgate anti-merger rules, such as the ones it now proposes. After all, railroad merger policy is of fundamental importance both to national transportation policy and the economy more generally. Thus, it would be completely implausible, and highly improper, to assume that Congress intended to delegate to the agency, sub silentio, the authority to promulgate

Existing law clearly favors mergers that increase efficiency. Both the 4R Act of 1976 (Pub. L. No. 94-210, 90 Stat. 31) and the Staggers Rail Act of 1980 (Pub. L. No. 96-448, 94 Stat. 1895) reflected "Congress' endorsement of mergers that enhance railroad efficiency." Lamoille Valley R.R. Co. v. ICC, 711 F.2d 295, 302 (D.C. 1983). The ICCTA was intended to continue this pro-merger policy.

In enacting the ICCTA, Congress knew that the Class I railroads were entering a "new round of consolidation." 141 Cong. Rec. H12,253 (daily ed. Nov. 14, 1995) (statement of Rep. Shuster). Congress assumed that, as a result of such consolidations, "thousands of miles of track, whether we like or not, are going to be abandoned." *Ibid.* Notwithstanding Congress's knowledge of the very factors that the Board now invokes to justify replacing the existing Congressional merger policy, Congress, in the ICCTA, elected to continue the existing merger policy. *See, e.g., id.* at S17,588 (daily ed. Nov. 28, 1995) (statement of Sen. Pressler) ("Absent some compelling reason for change, which has yet to appear, the current process should stand."); *id.* at S17,821 (daily ed. Nov. 29, 1995) (corrected version of Senator Pressler's remarks); *id.* at S17,590 (daily ed. Nov. 28, 1995) (statement of Sen. Hutchison) (noting concerns about railroad mergers, but stating that "[w]e have the ability to judge the issues under the standards we have had before"); *see also* Disposition of the Railroad Authority of the Interstate Commerce Commission: Hearings before the Subcommittee on Railroads of the Committee on Transportation and

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rules forbidding private restructuring initiatives. As the Supreme Court noted in a similar context, "Congress could not have intended to delegate a decision of such economic and political significance in so cryptic a fashion." FDA v. Brown & Williamson Tobacco Corp., 529 U.S. 120, 120 S. Ct. 1291, 1315 (2000).

Infrastructure, House of Representatives, 104th Cong., 1st Sess. 106 (1995) (testimony of Gail C. McDonald, Chair of the ICC, stating that "[a]nother round of major rail consolidations is anticipated as the railroad industry strives to become even more efficient and offer 'seamless service'").

In fact, the Senate rejected a proposal to respond to increasing rail industry concentration by subjecting merger proposals to an antitrust analysis that would have been more rigorous than the existing public interest analysis used by the ICC. *See* 41 Cong. Rec. S17,585-17,590 (daily ed. Nov. 28, 1995) (debate among Sens. Dorgan, Bond, Pressler, and Hutchison). In arguing against the proposal, Senator Pressler noted that, although "[i]n the last 15 years, there have been roughly a dozen rail mergers, a tremendous increase in concentration when just measured by the number of railroads," the public interest standard used by the ICC should not be changed. *Id.* at S17,588; *see also id.* at S17,820 (daily ed. Nov. 29, 1995) (corrected version of Senator Pressler's remarks). In the course of the debate on the proposal, Senator Pressler pointed out that "many rail efficiencies can be achieved only through mergers." *Ibid.*

The Board's proposed rules, however, would undermine Congress' considered decision to maintain the then-existing pro-merger policy in the ICCTA. Accordingly, promulgation of these rules would contravene the Board's statutory authority.

The proposed rules also would be invalid because they are inconsistent with Congress's expressed intent that the ICCTA continue and advance a policy of deregulation of the railroad industry. The ICCTA was intended to reduce the regulation of railroads, not expand it. *See, e.g.*, ICCTA, § 10101(2), Pub. L. 104-88 (articulating U.S. policy "to minimize the need for Federal regulatory control over the rail transportation system"); H.R.

Rep. No. 104-311, at 82, 1995 U.S.C.C.A.N. 793, 793 ("The bill substantially deregulates the rail and motor carrier industries."); *see also* Ex Parte No. 529, Class Exemption for Acquisition or Operation of Rail Lines by Class III Rail Carriers Under 49 U.S.C. 10902, 1996 WL 339192, at *17 (served June 21, 1996) (Morgan, Chair, commenting) (referring to "deregulatory direction" of the ICCTA).

Congress's intent to continue its existing deregulatory policy was and is one of the most important features of the ICCTA. As noted, in deciding to stay the deregulatory course, Congress acted with full knowledge that the industry was likely to become more concentrated in the future. *See* 141 Cong. Rec. S17,579 (daily ed. Nov. 28, 1995) (statement of Sen. Pressler) (rejecting argument that increasing concentration in the industry required "reregulation," noting that "I am not convinced a return to a pre-Staggers approach is the answer"); *see also id.* at H12,253 (daily ed. Nov. 14, 1995) (statement of Rep. Shuster) ("[T]he rail part of this legislation repeals and reduces numerous regulatory requirements."); *ibid.* (statement of Rep. Shuster) ("The bill continues the basic structure of the Staggers Act under which the freight railroad industry has seen remarkable recovery, primarily due to the benefits of deregulation."); *id.* at S17,579 (daily ed. Nov. 28, 1995) (statement of Sen. Pressler) ("As a general principle, S. 1396 continues the deregulation theme of the past 15 years by providing further regulatory reductions in the surface transportation industries."); *id.* at S17,581 (statement of Sen. Exon) ("This legislation represents the latest chapter in a thoughtful and deliberate effort to reform and deregulate America's great transportation sector. The more we can deregulate it, the better it will be and the more service it will provide."); *id.* at H15,600 (daily ed. Dec. 22, 1995) (statement of Rep. Shuster) ("[The conference report] continues the basic structure of the Staggers

Act, under which the railroad industry has seen a remarkable recovery primarily due to the benefits of deregulation.").

The Board's proposed rules, however, would greatly expand the regulatory burdens facing potential merging railroads and would upset the "careful balance," *id.* at S17,580 (daily ed. Nov. 28, 1995) (statement of Sen. Pressler), that Congress struck with respect to the appropriate level of regulation. Accordingly, the proposed rules clearly violate the expressed intent of Congress.

The proposed rules cannot be salvaged by pointing to the need to address the growing concentration of the industry or by arguing that there no longer is a need to reduce excess capacity. As noted above, Congress was well aware that the industry would likely experience further concentration in the coming years, but nevertheless opted for a continuation of the pro-merger policy. If Congress determines that mergers are no longer in the public interest, it – but only it – can establish such a paradigm shift by revising the statutes that define the proper scope of Board review.

2. <u>There Is No Basis for the Presumption That Mergers Will Produce Generalized Competitive Harms</u>. There is no basis for the broad presumption that any future merger will necessarily cause generalized competitive harms. *See* Proposed 49 C.F.R. § 1180.1(a), NPR at 11.

The Board's current policies already require that a merger plan preserve competitive options for 2-to-1 shippers, 2-to-1 shortlines and regionals, build-in and build-out opportunities, and transloads. Thus, any merger applicants already know, even without the NPR, that they must mitigate any such competitive harms.[23]

Despite these precedents, the Board apparently is concerned about the potential loss of more generalized competition, such as product and geographic competition. However, it is not clear how geographic and product competition would be adversely affected by the end-to-end mergers that are likely to be proposed in the future, particularly given the open gateway and contract exception proposals contained in the NPR.[24]

Furthermore, if these concerns are legitimate, there is no reason why the Board cannot consider, as it has in the past, whether geographic and product competition would be reduced, under the facts of an actual merger, in specific markets and, if so, what specific remedies are required to offset any identified harms.[25] A focused review of geographic and

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[23] "[A]s railroads have consolidated, the Board (and its predecessor, the ICC) has been vigilant in protecting the rail options of shippers. In the context of merger policy, the Board has established a strong precedent to preserve options for a shipper who had access to two rail options prior to a proposed merger. Indeed, merging parties no longer appear before the Board without . . . first ensuring that their transaction preserves access to at least two rail options. This bespeaks clear and forceful policy aimed at protecting competition and the public interest." V.S. Gómez-Ibáñez /Kalt at 12-13.

[24] "For the loss of geographic competition to be a significant issue in a merger proceeding, one needs to show that geographic competition was, prior to the merger, the constraining factor on the potential for the exercise of market power, and that the merger would eliminate such competition.

"Previous mergers have involved extensive evidentiary findings regarding the process of competition—inter-modal, intra-modal, and geographic—and the likely effect of the merger. Evidence and previous Board rulings indicate that most proposed mergers have not presented significant risks of competitive harm, once competition-preserving conditions have been granted. . . . The Board's ability to obtain similar evidence and perform similar analyses are unaffected by previous rail consolidation." V.S. Gómez-Ibáñez /Kalt at 16-17.

[25] "The Board has successfully obtained and evaluated evidence on the prospective competitive harm that a merger could pose. . . . There is no reason that the Board will be unable to make similar evaluations in the future." V.S. Gómez-Ibáñez/Kalt at 17. *See, e.g.*,

product competition issues also would ensure that any relief is directed at the shippers who otherwise would suffer a loss of competitive pressure on rail rates, rather than providing a windfall to competitors or other unaffected shippers. (Ironically, if the NPR is adopted, Board policy would irrebuttably presume that geographic and product competition would be harmed by any merger, while the Board's policies on shipper rate challenges would presume that geographic and product competition do not constrain the rates charged by railroads.)

Finally, mergers produce competitive benefits by increasing intermodal competition, encouraging railroads to invest in infrastructure and provide new service, and providing shippers with access to new markets. The general decline in real rail rates also demonstrates that mergers have maintained or enhanced intramodal competition. Therefore, the Board's presumption is based on an unwarranted projection of non-remediable competitive harm and a dismissal of the general competitive benefits that rail mergers can continue to produce in the future.

3. There Is No Basis for the Presumption That Mergers Will Cause Transitional Service Harms. There is no basis for the presumption that a merger will necessarily cause transitional service problems. *See* Proposed 49 C.F.R. § 1180.1(c)(2), NPR at 15.

First, the problems of the UP/SP and NS/CSX/Conrail transactions were truly unique. UP acquired a railroad that had under-invested for years and then, as UP has

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Union Pacific Corporation, et al. – Control and Merger – Southern Pacific Rail Corporation, et al., Finance Docket No. 32760 ("UP/SP") Decision No. 44 (STB August 12, 1996) at 124-32 (geographic competition), 146 (transloads and build-in/build-outs); Conrail, Decision No. 89 at 61-62 (build-in/build-outs and transloads).

acknowledged, there were some transitional personnel and operating problems. NS/CSX/Conrail involved an unprecedented – and unlikely to be repeated in the foreseeable future – division of the assets of an existing railroad. Neither of these facts is likely to recur in a future end-to-end merger.[26]

Second, the detailed service assurance plans and post-merger monitoring proposed by the NPR – and supported fully by BNSF – will ensure that merging railroads engage in a more detailed analysis of potential service problems and that interested parties have the ability to probe those plans. Proposed 49 C.F.R. § 1180.1(h), NPR at 20. The proposed rules build on the experiences of the past and require merger applicants to address in detail those areas that have led to problems in past mergers. Given the detail of these plans and the high level of review and monitoring the plans will receive from shippers and the Board, the final plans approved by the Board should minimize any such service problems.

In addition, BNSF proposed, in response to the ANPR and in public statements about the BNSF/CN combination, that merging railroads negotiate meaningful service guarantees with their shippers. BNSF also proposed that merger applicants provide evidence that their post-merger plans will generate the capital to support the infrastructure improvements necessary for the benefits of the proposed merger to be realized. Both elements would further lessen the likelihood of future major service disruptions.[27]

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26 The Board itself has recognized that despite the difficulties associated with the implementation, the UP/SP merger remains in the public interest. *See* UP/SP, Decision No. 15 (STB Nov. 29, 1999) at 5-6.

27 *See* V.S. Gómez-Ibáñez/Kalt at § IV for a discussion of appropriate methods for minimizing service disruptions.

Third, merged railroads will have every incentive to maintain service quality and to learn from the problems of the past. UP, CSX and NS paid a very high price, in lost revenues, damages, and credibility with their shippers, for their service problems. No railroad will want to repeat that experience.

Fourth, the NPR proposes to offset potential and transitory service harms with concrete and permanent competitive conditions. Proposed 49 C.F.R. § 1180.1(d), NPR at 16. This is not an appropriate matching of problems with remedies. Instead, any remedies should provide shippers with alternate access during any period in which the merged railroad is experiencing merger-related service problems.

In sum, the NPR already contains the appropriate approach to any service problems of the future – the filing of detailed service assurance plans, aggressive post-merger monitoring, and prompt service relief (including temporary access to other carriers) for adversely affected shippers. With these strategies and potential remedies in place, it is not appropriate to presume that more regulatory intervention is required. Accordingly, the final rule should not include this presumption.

C. Imposing a Substantially Heavier Burden, Including the Requirement of Unrelated Competitive Enhancements, on Future Railroad Mergers Would Be Bad Policy and Law. Because rail mergers can be structured to mitigate identified competitive harms, there is no basis for a presumption that generalized competitive harms must somehow be offset. Proposed 49 C.F.R. § 1180.1(d), NPR at 16. As Professors Jose Gómez-Ibáñez and Joseph Kalt explain in their Verified Statement:

> Previous experience and the recent evolution of the railroad industry do not suggest that future mergers will reduce competition in ways that cannot be identified or mitigated.... [P]ast mergers do not appear to have

> reduced the competitive pressures on the railroads. Competition has been preserved in part because railroads are subject to many sources of competition that are usually not affected by mergers. Railroads compete intensely with trucks and barges for many commodities and shipments, for example, and this inter-modal competition is not reduced by rail mergers. . . .
>
> The Board has also played an important role in preserving competition by insisting that merger applicants offer trackage rights or other remedies that insure that any shipper served by two or more railroads before the merger still has a choice of at least two railroads after. Substantial evidence over the past several years and mergers indicates that Board-imposed and/or privately negotiated trackage, haulage and other conditions to preserve competition have been effective. V.S. Gómez-Ibáñez/Kalt at 14-15.

Similarly, for reasons discussed above, a presumption should not be adopted that rail mergers invariably produce service failures affecting rail customers, communities, or employees. Therefore, there is no basis for requiring merging railroads to offer unrelated "competitive enhancements" that could deter future mergers that would serve the public interest.

BNSF has supported the concept of raising the bar for mergers in the specific areas that have been identified as problems in recent mergers, including transitional service problems and the problems that might be created by transcontinental mergers, such as open gateways. However, that process should not become a means to alter the statutory basis of determining the public interest or a vehicle to reject the benefits of good mergers. There is a fundamental difference between raising the bar, as BNSF has proposed, and creating potentially insurmountable barriers, as the NPR proposes.

It is not appropriate to require that rail mergers <u>enhance</u> competition.[28] If a merger would maintain effective intramodal competition for those shippers who now have it (as, for example, Board policy requires that it must for all 2-to-1 shippers) and would offer significant public benefits, it would be a mistake to deny the public and the railroads the benefits of the merger. That policy would harm shippers and adversely affect the ability of railroads to attract the capital necessary to invest in infrastructure. Therefore, applicants should not be burdened with the requirement that they offset abstract presumed losses in competition with unrelated competitive enhancements.

Although the Board has disavowed a blanket "open access" requirement, merger applicants would appear to be compelled to make at least limited access concessions in order to meet the requirement for competitive enhancements. In his Verified Statement, Professor Richard J. Pierce explains why the Board's proposal to require applicants to incorporate proposals for enhanced competition is a bad idea.

> First, if the Board is convinced that some major change in its regulatory policy, like an equal access requirement, would yield significant public benefits, the efficacy of that policy change will depend primarily on its scope. It would make little sense, and do little good, to impose it selectively on railroads that propose to merge. Instead, the agency should consider whether to apply the new approach to all railroads.
>
> Second, adopting a policy of approving mergers only if the applicants agree to adopt a major change in their methods of operation that they consider highly undesirable is much more likely to discourage railroads from proposing socially beneficial mergers than to produce a legal regime in which many railroads agree to the change as a condition on approval of a merger.

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[28] The NPR appears to ignore the pro-competitive aspects of rail mergers, which often result in increased inter- and intramodal competition. V.S. Krebs at 6-7. "This new presumption ignores the fact that modern rail mergers have made railroads more effective competitors thereby improving the competitive marketplace served by all modes of transportation." *Id.* at 7.

Third, the policy would require the Board to determine what level of enhancements are necessary to offset possible harms and then allocate those enhancements to shippers who are not, by definition, directly affected by the potential harm. The unfairness inherent in providing benefits to one class of shippers, rather than another, is a key reason why remedies should be designed to offset specified harms to specific groups.

Fourth, and most important, no agency should consider adopting a major change in its regulatory policy, like an equal access rule, without considering carefully and in detail all of the implications and effects of adopting the new policy. That cannot be done as an add-on to a merger review proceeding. It requires instead a separate rulemaking in which the agency addresses with care the scores of important issues that are raised by such a proposed policy change. V.S. Pierce at 17-18.

Further, if some shippers would suffer cognizable competitive harms as a result of a proposed merger, relief should be crafted to address those specific harms. The pursuit of broader remedies would be unfair to the harmed shippers and would raise very significant questions about the future regulatory structure of the rail industry.

For example, as the Board stated, one potential competitive enhancement could be the adoption of a limited system of open access or the elimination of paper and steel barriers for Class II and III railroads. NPR at 16-17 (discussion of Board's authority under Proposed § 1180.1(d)). However, unless such remedies were imposed on a uniform national basis, the merged railroad would be placed at a significant competitive disadvantage. The Board also could expect to hear pleas for relief from shippers and Class II and III railroads who would not benefit from the specific enhancements proposed in a merger proceeding.[29] Again, any such structural changes should be imposed only on a uniform basis.

[29] "The problem of rent-seeking will be exacerbated by shippers seeking relief before the Board and the Board needing to decide which shippers will get what kind of benefit from 'enhanced competition' and in what form this condition will occur." V.S. Gómez-Ibáñez /Kalt at 19.

The NPR also would create barriers to future mergers by allowing the Board to decide whether the claimed benefits of any merger could be achieved through means short of merger, such as alliances and marketing arrangements, that no party has actually proposed. Proposed 49 C.F.R. § 1180.1(c), NPR at 12-13. However, there are sound economic reasons to believe that mergers will be more efficient in the long-run than joint ventures.[30] Furthermore, proper market incentives exist for management to choose the

[30] "We can imagine a hypothetical rail network in which each successive mile of track is owned by a different railroad. In such a situation, . . . decisions . . . would need to be coordinated through negotiations or complex contracts involving multiple parties that set out as many foreseeable contingencies as possible, perhaps simplifying or ignoring certain economic interactions. Since there are significant costs associated with writing complex contracts or engaging in ongoing negotiations, we do not see the foregoing ownership structure in railroading. Rather, we observe integrated railroads with significant geographic scope to their ownership and operations. . . .

"Contractual relationships often require parties to bear large transaction costs, particularly when agreements must be closely monitored to ensure compliance. Real world negotiations include a high level of uncertainty and differences in expectation about both the current state of the world (e.g., the ability of coordinated service to attract new business immediately) and the future (e.g., how the agreement will evolve). This makes it difficult to reach, monitor, and enforce mutually beneficial marketplace agreements. When parties have different information, different expectations, and different alternative opportunities, they will also tend to value the benefits of a relationship differently. . . .

"Even when firms can agree on the benefits, they tend to have their own financial interests and priorities. Under such circumstances, writing sufficiently complex contracts to incorporate the myriad details and contingencies needed for successful integration is quite difficult. . . . [F]irms behave reasonably and tend to protect their individual interests, insisting on their individual priorities and strategies. This can make full coordination infeasible. Customers' needs go unserved and 'money is left on the table' . . . . Capturing such business provides the lure to mergers that improve network coordination by bringing the problems and incentives under the control of single ownership.

"The problem of inducing mutually beneficial arm's-length arrangements is doubly hard when durable capital needs to be sunk and shared to realize the benefits of economic success. Issues related to how to apportion capital expenditures across parties are especially difficult when the benefits that accrue from such an investment will be distributed across the network. . . . These factors act to limit independent firms' willingness to commit necessary capital to investments that an integrated firm would readily undertake. Under such circumstances, customers' needs can go under-served and, to capitalize on the business opportunities this creates, efficient marketplace forces push companies to bring more efficient alternative as between mergers or joint ventures in each particular instance, and there is no reason to believe that the Board would make better decisions by second-guessing management.[31] Thus, it would be bad public policy for the Board to reject a merger that creates no concrete harm and promises public benefits merely because the Board prefers alliances to mergers.

In addition, the NPR would create barriers to future mergers by adopting rules that are unacceptably vague. Under the current rules and precedents, merger applicants know precisely what competitive harms they must mitigate, and the Board can review whether each such harm is adequately mitigated by proposed conditions. However, the NPR requires that merger applicants propose competitive enhancements to offset unrelated presumed competitive and transitional service harms. Proposed 49 C.F.R. § 1180.1(d), NPR at 16. It would be impossible for merger applicants to propose offsets to harms that cannot be precisely identified or quantified. Neither the Board nor interested parties would have any meaningful guidelines for identifying the type or extent of enhancements required to offset harms that the parties may be unable to identify or assess.[32]

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operations that need to be coordinated over the use of long-lived, sunk capital under the roof of one firm." V.S. Gómez-Ibáñez/Kalt at 23-25.

[31] In fact, Board-imposed "conditions are likely to be more unwieldy, arbitrary, and inefficient than arrangements reached through private two-party negotiation." V.S. Gómez-Ibáñez/Kalt at 19.

[32] Moreover, the Board's proposed rules are so vague that they would render merger review virtually standardless. For instance, the proposed rules make merger approval contingent on whether some undefined quantum of "competitive enhancements" will outweigh some unspecified level of harm that is presumed to result from any and all railroad mergers. Such criteria for determining whether to approve a merger are devoid of any "intelligible principle" to cabin the agency's exercise of its discretion. J. W. Hampton & Co. v. United States, 276 U.S. 394, 409 (1928). Accordingly, the Board's proposed rules, if promulgated, would constitute an unconstitutional delegation of legislative authority,

Finally, the proposed rules would encourage abuse of the regulatory process by interested parties.[33] For example, a competing railroad could propose enhancements in its competitive position (or, more subtly, encourage shippers, shortlines or communities to propose such enhancements) to offset the hypothetical problems of its competitors' proposed merger. Shippers could seek new options to offset presumed losses of geographic competition that do not even affect them. The Board would have no reasoned basis for weighing these requests, and the regulatory process would be held hostage by parties who would be encouraged to use any merger proceeding as an opportunity for regulatory blackmail. Further, the proposed rules also would place the Board in the unprecedented and unjustified position of picking winners and losers in the general economy by deciding which shippers or sectors of the economy will be the beneficiaries of any enhanced competition conditions. The Board, for example, would have to decide which chemical shippers receive additional competitive benefits or, instead, whether coal shippers will be targeted for benefits, rather than agricultural shippers. This is not a role the Board should fill, and the problem of selecting winners and losers demonstrates why the Board

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particularly since, as the Board itself has acknowledged, railroad mergers and merger policy affect the entire economy. *See* American Trucking Ass'ns v. EPA, 175 F.3d 1027, 1034-37, modified on reh'g, 195 F.3d 4 (D.C. Cir. 1999), cert. granted, 120 S. Ct. 2003 & 120 S. Ct. 2193 (2000); International Union, UAW v. OSHA, 938 F.2d 1310, 1317-1318 (D.C. Cir. 1991); STB Ex Parte No. 582, Public Views on Major Rail Consolidations, slip op. at 2 (served March 7, 2000) (rail merger policy and potential disruptions caused by mergers may affect "the national economy and defense").

[33] "Any and all shippers, regardless of the merit of their position, will have the incentive to seek conditions that grant them more than they currently have." V.S. Gómez-Ibáñez/Kalt at 18. The proposed rule "would maximize the opportunities for competitors and other third parties to abuse the merger approval process by using it to stop or to delay a pro-competitive merger or to use it as means to extract special favors unrelated to the proposed merger." V.S. Pierce at 12.

should limit its review to imposing specific conditions designed to offset or remedy specific merger-related harms.

D. Applicants Should Be Required to Address Only Concrete Downstream and Crossover Effects of a Proposed Merger. The NPR would require that merger applicants address the downstream and crossover effects of the proposed merger. Proposed 49 C.F.R. § 1180.1(i), NPR at 21. In its comments on the ANPR, BNSF proposed that merger applicants (i) demonstrate that they will not create crossover effects by exporting service problems to other railroads, and (ii) assess any new competitive problems with their merger that would be created by any subsequent merger that is filed with the SEC by the time that the first round of intervenor comments is due under the procedural schedule.

The Board's concern with downstream effects runs directly contrary to its presumption that future mergers will not produce competitive and other public benefits. After all, a "responsive" merger would be "necessary" only if the first merger creates new competitive pressures. If a merger did not produce a more efficient competitor, there would not be a responsive merger.

Furthermore, it is not clear what the Board would or could do with these projections. If a pending merger would produce public benefits, the Board should not reject the merger because a potential responsive merger might be harmful to the public interest. Instead, the Board should reject or condition the responsive merger if it is actually filed. It would be inappropriate for the Board to cure any potential deficiencies in a subsequent merger by imposing conditions on a prior merger.

Injecting these issues, without appropriate limits, into the merger review process would inevitably result in an abuse and prolongation of the regulatory process. Contesting railroads and shippers would have the incentive to posit responses and problems simply to delay, complicate and defeat a pending merger proposal. Furthermore, it would be impossible and speculative for any railroad to present a case on all the potential strategic reactions to its proposed transaction, and the Board would have no reasoned basis to select among various hypotheticals announced by the parties.

The NPR could be read to suggest that the Board has preferred outcomes in any further consolidation of the rail industry. However, experience teaches that the selection of merger partners is best left to the forces of the market, subject to the protection of competition. Furthermore, if the Board, quite improperly, rejects a proposed merger because it favors another combination, the Board would lack the authority to force unwilling partners to combine, and it would be bad policy for it to attempt to do so.

The NPR also could be read to suggest that the Board favors a "competitive balance," one in which railroads compete at the margins but are guaranteed a basic market share. While the Board's governing statutes call for the preservation of essential services to shippers, the reforms of the 4R Act and the Staggers Act were explicitly intended to end the days when regulators allocated markets.

The broad downstream effects analysis proposed by the Board could lead to perverse results. For example, suppose that Merger 1 would be considered to be in the public interest, under whatever standards the Board adopts, except that Merger 1 might provoke the filing of Merger 2, a merger that the Board believes would not be in the public interest. The Board should not reject Merger 1 based on the speculation that Merger 2 might be filed in response and might have bad results. Merger 2 can be dealt with on its own merits. In no event should the Board impose conditions on Merger 1 to remedy problems that are created by, and internal to, Merger 2.[34]

Similarly, suppose that Merger 1 is a surprise to the Board, either because of the timing or the identity of the parties. This does not mean that the Board should refuse to approve Merger 1 because it prefers a different pairing. Congress has rejected this command-and-control approach to regulation of railroads. Further, if the Board has views on the appropriate regulatory structure of the industry, such as open access issues, those views should, to the extent allowed by statute, be addressed through a rulemaking of general applicability.

However, there are legitimate downstream and crossover issues for the Board to consider, as BNSF noted in its comments on the ANPR. These issues are tied directly to the appropriate scope of Board review of mergers – competitive and service issues. Thus, it would be appropriate for the Board to review whether an actual responsive merger somehow vitiated the effectiveness of remedies imposed to protect 2-to-1 shippers. Similarly, the Board should assure that a merger will not result in the export of service problems to other railroads. Of course, both of these concerns are already covered in other areas of the NPR.

[34] "Even if it were possible to predict future mergers with accuracy, it would be inappropriate to use such predictions to block a proposed merger. Each application should be judged on its own merits, according to the principles of sound merger policy. The 'looming possibility' of subsequent merger applications is no reason to prevent a proposed combination that meets traditional merger policy criteria. . . .

"The goals of sound merger policy would be better served by a more limited measure that would require a merger applicant to consider the effect of any concurrent merger application." V.S. Gómez-Ibáñez/Kalt at 29.

E. Applicants Should Not Be Subject to the Future Imposition of Conditions to Their Mergers or Required to Guarantee the Specific Projected Benefits of a Merger. Merger applicants and other parties require assurances that Board action with respect to any merger will be final, except as necessary to remedy any transitional service problems or any competitive conditions that prove to be inadequate. The use of the Board's post-merger conditioning power to remedy these narrow categories of merger-related problems could be appropriate, in some circumstances, because it would be crafted to preserve the service and competitive results promised by the merger applicants and approved by the Board. However, the NPR proposes to reserve to the Board the authority to impose post-merger conditions under a much wider variety of circumstances.

The NPR proposes that the Board will retain the right to impose new conditions on a merger in response to unforeseen circumstances or subsequent mergers. The "unforseen circumstances" test is so broad that a merged railroad always would be subject to the risk that the Board would impose conditions that would not have been acceptable as an original precondition to the merger. The industry requires certainty, but this proposal removes it entirely. Furthermore, if a subsequent merger takes place, any problems created by the second merger should be remedied only through conditions imposed on that merger, without requiring a previously merged railroad to contribute to the resolution of service or competitive problems that were created by the second merger.

The NPR also states that merger applicants must propose how they would be held accountable for the benefits and service improvements they claim. Proposed 49 C.F.R. § 1180.1(c)(1), NPR at 14. The Board's proposal is overly broad, mixing areas where continued Board oversight is necessary and appropriate with areas where continued Board oversight would be harmful and contrary to sound public policy. The proposal would deny merging railroads the ability to weigh a complete set of conditions in deciding whether to proceed with their merger after receiving Board approval.[35] The threat to impose additional conditions if projected public benefits are not met is bad public policy.[36]

Oversight by the Board of implementation of competitive conditions is appropriate. If remedies for 2-to-1 shippers or the new open gateway policies do not work, for example, it would be appropriate for the Board to act, using its conditioning powers. The Board has done so in the past.

The Board also should monitor service implementation with a readiness to use its service order power to address service breakdowns, as it has done in the past. In fact, the Board has clarified and expanded its procedures, as a result of the UP/SP and Conrail problems.

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35 As the Board itself has recognized, once a merger has been consummated and the applicants can no longer walk away from it, the "imposition of disproportionate new conditions becomes increasingly inconsistent with notions of commercial certainty and fairness." Union Pacific Corp., et al. – Control and Merger – Southern Pacific Rail Corp., et al. [Houston/Gulf Coast Oversight], Finance Docket No. 32760 (Sub-No. 26), Decision No. 10 (STB Dec. 21, 1998), at 3.

36 "This proposal completely misses the point of a dynamic marketplace – shippers can benefit from competitive responses to mergers that may deprive the merging parties of the expected traffic, but which in fact produce lower rates or better service for shippers. Such a result cannot be considered harmful to the public interest, and no intervention from the Board should be needed to address the failure of merging carriers to gain as much new traffic as they had hoped to gain." V.S. Krebs at 10–11. "The estimated public benefits of a merger are inevitably based on forecasts of many uncertain variables. . . . Actual benefits may diverge from projected because of events that are unexpected and completely outside the control of the merger applicants. Everything from changes in the overall economy or the weather could result in forecasts being inaccurate – in either direction – after the fact." V.S. Gómez-Ibáñez/Kalt at 30-31.

However, beyond that, it is not clear what role government appropriately can have to ensure "accountability" for the claimed improvements. It is manifestly in the applicants' best interest to do all they can to make the service improvements and implement the efficiencies of the transaction as seamlessly as possible. But the applicants cannot be held responsible for unforeseen developments in their shippers' businesses, in the competitive dynamics of the industry, or in the economy as a whole that may adversely affect their projections.[37]

For example, the NPR could be read to suggest that, somehow, a merged railroad could be subject to the imposition of additional conditions if the results of traffic diversion studies were not realized. However, a merged railroad might not capture projected traffic precisely because of the competitive ("downstream") responses of other railroads, trucks and barges, with the result that shippers receive even more benefits than the merging parties suggested. Similarly, a merged railroad might not achieve projected labor savings because of unanticipated success in attracting new traffic or because it decides to be more cautious in implementing future personnel reductions in the interest of service integrity, again to the benefit of shippers. This is why the current Board merger policy – focused on the competitive and service effects of a merger – is both the correct policy and the only policy that can be enforced with any logic or reason.

[37] "Some mergers produce disappointing results – results that fall well short of the firm's expectations. Agencies do not approve mergers because they expect all mergers to be successful. Such an expectation would be absurd. It is contradicted by history. Some mergers yield spectacular results; some yield terrible results. Agencies approve mergers that do not have anticompetitive effects because they know that many will yield good results and because they know that the firms that propose to merge are in a much better position than any agency to predict the results of the merger." V.S. Pierce at 20.

Finally, the proposed accountability standard could have the result of discouraging the merged railroad from rethinking its plans in light of changing circumstances. The proposed review would encourage railroads to take unwise actions solely in order to reach regulatory benchmarks, rather than to achieve competitive and service results. The review also could force a merged railroad to proceed to the next step of its integration plan, even if problems have been identified and remain unresolved. These are not desirable results.

In summary, the Board's current policy is the correct one. The Board should act to protect shippers when competition-related conditions prove to be ineffective. The Board should act to provide shippers with relief when service is disrupted due to merger-related problems. However, there is not a broader post-merger role for the Board to play.

F. The Board Should Not Dictate the Structure of Future Business Relationships. The NPR states that, in assessing whether a merger is in the public interest, the Board will consider whether the claimed benefits could be realized in other ways, such as joint marketing ventures, alliances and other mechanisms. Proposed 49 C.F.R. § 1180.1(c), NPR at 12-13. However, railroads recognize the extensive time and effort that mergers require. When they choose mergers over alliances and other types of voluntary coordination agreements, they do so because mergers are more likely to achieve the efficiencies they need.[38] A merged entity will be better positioned to respond to future problems, including natural disasters, because of its ability to make decisions that reflect the balancing of the requirements of the entire system, rather than that part of the system served by each railroad in an alliance.

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38 *See* § VI of V.S. Gómez-Ibáñez/Kalt for a discussion of non-merger transactions.

Railroads will choose among alliances, other forms of voluntary cooperation, and mergers based upon their assessment of which form will produce the greatest benefits. These decisions will be made with a full awareness of the requirements that the Board will impose on any merger. Indeed, given the burdens imposed on merger applicants, if alliances and joint ventures are an efficient means of increasing efficiencies and becoming competitive, railroads will continue to pursue them. However, in the final analysis, sound economic and regulatory policy requires that the Board defer to the decisions by capital markets on the best way to structure business enterprises, unless those decisions would result in identifiable harms that cannot be mitigated.[39]

G. The Board Should Require Merger Applicants to File Service Assurance Plans and Should Monitor Post-Merger Implementation. The NPR proposes that merger applicants prepare an extensive service assurance plan to address the risks of service problems and implementation. Proposed 49 C.F.R. § 1180.1(h), NPR at 20. BNSF has already endorsed the concept of service integration plans and would continue to support "service assurance plans" as an addition by rule to the requirements of an application, as suggested in our comments in the ANPR phase. The plans would involve protection of service integrity for shippers during the merger implementation process, and include plans made in conjunction with connecting rail carriers, including Class II and Class III carriers, as well as ports. However, as discussed above, the filing and testing of a service assurance plan should negate any presumption that a merger will produce transitional

[39] "Regulatory limitations on a railroad's use of its assets and uncertainty about future limitations act not only as disincentives for the railroads to invest in particular projects but also as disincentives for outside investors to invest in the railroad." V.S. Cornell at 9.

service problems that must be weighed against the merger as part of the public interest balancing.

The NPR also proposes that the Board conduct extensive post-approval operational monitoring to help ensure that service levels after a merger are reasonable and adequate. Proposed 49 C.F.R. § 1180.1(h), NPR at 20. BNSF supports this proposal. The merging carriers should propose the relevant datapoints to be monitored, the specific metrics to be provided to the Board and others, and the processes to be used to conduct the post-approval operational monitoring.

H. The Board Should Require That Affected Major Gateways Remain Open, 2-to-1 Situations Be Remedied, Including Build-In/Build-Out and Transload Opportunities, and "Contract Exception" Rights Be Retained. In proposed Section 1180.6(b)(10), the NPR proposes that merger applicants must demonstrate how the use of major gateways will be preserved. BNSF supports adoption of a requirement that applicants demonstrate how access to markets and viable service offerings through major open gateways would be maintained operationally and financially. However, this requirement should apply only to points directly affected by the merger; there is no merger-related policy basis for extending this requirement to gateways not affected by a merger.

The NPR proposes that merger applicants must demonstrate how build-in/build-out and transload options would be preserved. Proposed 49 C.F.R. § 1180.6(b)(10), NPR at 31. To the extent that a shipper would lose such options, such a demonstration would be appropriate with respect to 2-to-1 situations, along the lines of the CMA Agreement and the conditions adopted in UP/SP.[40]

[40] *See*, UP/SP, Decision No. 44, at 18.

The NPR proposes that merger applicants must demonstrate how they would preserve the bottleneck contract exception. Proposed 49 C.F.R. § 1180.6(b)(10), NPR at 31. To the extent a shipper would lose a remedy as a result of a proposed merger, BNSF agrees that preservation of the contract exception would be appropriate.

I. Other Issues Raised by the NPR.

1. Transnational Transactions. The NPR proposes that a full-system competitive analysis and operating plan must be provided in cases involving Canadian or Mexican railroads. Proposed 49 C.F.R. § 1180.1(k), NPR at 21-22. BNSF does not oppose reasonable requirements in this area relating to railroads operating in Canada and Mexico as well as the U.S., particularly as they relate to North American Free Trade Agreement ("NAFTA") traffic and influences on each country's international trade abilities and commitments, issues of safety requiring involvement or cooperation with the Federal Railroad Administration, issues of conflicting economic regulation in Canada and/or Mexico as they affect the operation of the free market in the United States, or issues relating to national defense.

However, the Board should not presume transnational transactions to be contrary to the public interest, and should not discriminate against them. For example, it would not be appropriate for the Board to attempt to forestall the traffic shifts that might result from shippers' responses to the creation of a rail network that is more efficient and has a broader geographic scope.

2. Labor Issues. The NPR proposes that merger applicants must file additional employee impact information, including cross-border data for transnational

mergers. *See* Proposed 49 C.F.R. § 1180.1(e), NPR at 21-22. BNSF supports this position.

The NPR also states that contract override of labor agreements ("cramdown preemption") is to be very narrowly applied, and it states that the Board may impose additional labor conditions if appropriate. Proposed 49 C.F.R. § 1180.1(e), NPR at 17. However, Congress has defined when cramdown conditions are to be used and the scope of such conditions. Any change in this area should come from Congress.

While BNSF does not believe that the Board can ignore the statutory mandates when voluntary efforts fail, BNSF supports direct negotiations between unions and the merger candidates as the best mechanism for resolving labor issues. BNSF was successful in reaching agreements with labor when it was pursuing its combination with CN, and it would hope for similar success in connection with any future combination proposals. Furthermore, if such negotiations are to succeed, the Board need not and should not involve itself in reviewing or approving voluntary labor implementation agreements.

3. <u>Market Data in Support of a Merger Application</u>. The NPR proposes that an application include expanded market data, including detailed market share data that previously has not been furnished in merger cases. *See* Proposed 49 C.F.R. § 1180.7, NPR at 33-34. BNSF would not oppose reasonable requirements in this area, but the requirements should reflect what is practical from a data standpoint and recognize intermodal competition and the Board's precedents on the types of competitive effects that need to be remedied as part of the merger review process.

For example, proposed Section 1180.7(a)(3) appears to require actual and projected market share data by origin/destination area and major commodity group for individual transportation modes. Such data may not be available for trucks and barges at the level of specificity that the proposed rule may contemplate. Similarly, such detailed data may be unavailable, for example, in Mexico for any mode. The Board should make clear that its data requirements are not hard and fast, but are tempered by what is practical to obtain.

The Board also should ask whether the added burden of collecting and analyzing this data is justified. Because of its unique operating characteristics, traditional market share analysis is not appropriate in the rail industry, where a large number of shippers have always been sole-served and where many markets are subject to competition, but served by a single carrier due to long-term contracts. Instead, Board review has looked to the loss of existing competitive alternatives, not changes in market shares.

More fundamentally, the Board should reject any implication that it will use market data to ensure that a merger does not affect the market shares of other railroads. The competition created by mergers is good for the general public and shippers, and no railroad should be insulated from the changes in market shares that such competition brings.

4. Upstream Effects. The NPR specifically addresses "downstream" effects, although, as discussed above, the proposal is far too broad. There also is an issue concerning "upstream" effects – that is, the effects on conditions imposed on a prior merger when that merged railroad is itself an applicant in a subsequent merger.[41]

[41] As noted above, it would be contrary to statute and bad policy for the Board to remedy the problems associated with a proposed merger by imposing conditions (including the reopening of old conditions) on other parties.

BNSF believes that it is appropriate for the Board to take such "upstream effects" into account, provided that the emphasis remains on protecting the competitive interests of shippers and not the competitive position of railroads. For example, if a condition was imposed to protect a 2-to-1 shipper in a prior merger involving one of the merger applicants, it would be appropriate to review whether the condition would remain viable after the merger.

5. Technical Changes. The NPR proposes various technical revisions to the existing merger rules to codify a number of the Board's current practices and to conform the rules to the waivers and clarifications that the Board has granted in recent merger proceedings. BNSF is in agreement with the proposed revisions and notes that their adoption should enable the Board to process and complete its review of a proposed merger transaction within the maximum review period of one year from the date of the pre-filing notification which BNSF has proposed above.

IV. CONCLUSION

BNSF supports those specific elements of the NPR that would require merger applicants to file an application that addresses how the merged railroad will implement the merger, whether 2-to-1 shippers will retain effective competitive options after the merger, and whether the merged railroad will have an open gateway policy and preserve "contract exception" rights for affected shippers.

However, the Board must expedite its merger review process to meet the demands of capital markets and shippers. No merger review should take longer than one year, and some mergers can and should be handled in even less time. Further, the Board should not – and cannot legally – presume that mergers have no further role to play in improving the existing railroad system, in creating new efficiencies, or in providing the capacity and services necessary to provide shippers with the services they need in the modern economy. The Board should not presume that future mergers will create competitive and service problems that must be offset by unrelated competitive enhancements. Instead, the Board should review closely the details of each merger proposal, identify any probable competitive or service harms, and review the adequacy of the applicants' proposals for preventing those harms on the record in that case. The Board's review should be specific, not presumptive, and remedies should focus on correcting identified problems, not offsetting presumed, unidentified harms.

The Board should not require merger applicants to address purely hypothetical responsive mergers, nor should the Board reject a merger because it does not fit into the Board's preconceived notions of what shape the final North American rail system should take. The Board should adopt rules that allow all parties to make reasonable predictions about Board action, and the Board should not construct a system which encourages opportunistic parties to seek self-serving conditions to "offset" unspecified, unquantified, hypothetical but presumed harms.

These actions will ensure that future mergers serve the public interest; that Board policy does not discourage mergers that would produce public and private benefits; and that the Board acts in a timely fashion, given the demands of today's economy. These actions will raise the bar in an appropriate fashion, without creating presumptions that are contrary to sound economic and regulatory policy and in violation of law. These actions also will provide the signal of regulatory stability that is essential if the railroad industry is to attract and retain the capital necessary to meet the Nation's requirements for a competitive and reliable rail sector.

Respectfully submitted,

Erika Z. Jones

Jeffrey R. Moreland
Richard E. Weicher
Michael E. Roper
Sidney L. Strickland, Jr.

The Burlington Norther and
Sante Fe Railway Company
2500 Lou Menk Drive
Fort Worth, Texas 76131-0039
(817) 352-2368

Erika Z. Jones
David I. Bloom
Robert M. Jenkins III
Adiran L. Steel, Jr.
Roy T. Englert, Jr.

Mayer, Brown & Platt
1909 K Street, N.W.
Washington, DC 20006-1101
(202) 263-3000

November 17, 2000

Attachment 1

PROPOSED PROCEDURAL SCHEDULE

(The term "F" designates the date of filing of the application and "F+n" means "n" days following that date.)

F	Primary application and any related applications filed.
F+7	Notice of intent to prepare an EIS and request for comments on proposed EIS scope published in the Federal Register.
F+15	Board notice of acceptance of primary application (and any related applications) published in the Federal Register.
F+30	Safety Integration Plan due.
F+45	Draft of final EIS scoping.
F+60	Notification of intent to participate in proceeding due. Description of anticipated inconsistent and responsive applications due; petitions for waiver or clarification due with respect to such applications.
F+90	Inconsistent and responsive applications due. All comments, protests, requests for conditions, and any other evidence and argument in opposition to the primary application due. Comments by U.S. Department of Justice ("DOJ") and U.S. Department of Transportation ("DOT") due.
F+105	Notice of acceptance (if required) of inconsistent and responsive applications published in the Federal Register.
F+110	Date of draft EIS.
F+120	Response to inconsistent and responsive applications due. Response to comments, protests, requested conditions, and other opposition due. Rebuttal in support of primary application and related applications due.
F+150	Rebuttal in support of inconsistent and responsive applications due.
F+155	Comments on draft EIS due.
F+180	Briefs due, all parties (not to exceed 60 pages for applicants and not to exceed 30 pages for others).
F+205	Date of final EIS.
F+210	Oral argument (close of evidentiary record).
F+220	Voting conference (at Board's discretion).
F+270	Date of service of final decision.

Merger Summary/Timeline (1997-2000)

No.	Principal Merging Entities	Market Value (approximate)	Announcement Date	Completion Date	Total Time	Procedural History & Relevant Factors
1	AirTouch Communications Inc./ Vodafone Group Plc	$62 billion transaction value	January 15, 1999	June 30, 1999	5+ months	• FTC grants early termination of HSR Act waiting period March 3, 1999; • EC conditional approval May 24, 1999; • Shareholder approval June 1, 1999; • FCC approval June 23, 1999.
2	American Stores Company/ Albertson's, Inc.	$11.7 billion transaction value	August 3, 1998	June 2[illegible], 1999	10+ months	• FTC files HSR Act request for additional information October 2, 1998; • Stockholder approval 11/12/98; • Divestiture agreement with FTC clears merger June 22, 1999.
3	Ameritech Corp./ SBC Communications Inc.	$62 billion transaction value; $146 billion combined assets	May 11, 1998	October 8, 1999	16+ months	• EC & other European entities approval July 23, 1998; • Application filed with FCC July 24, 1998; • Divestiture agreement with DOJ clears merger March 23, 1999; • State entities approval August 9 through September 23, 1999; • FCC conditional approval October 8, 1999.
4	Amoco/ BP	$55 billion transaction value	August 11, 1998	December 31, 1998	4+ months	• EC approval December 14, 1998; • Divestiture agreement with FTC clears merger December 30, 1998.
5	AMP Inc./ Tyco International Ltd.	$12.22 billion transaction value	November 23, 1998	April 2, 1999	4+ months	
6	Asda Group plc/ Wal-Mart Stores, Inc.	$10.8 billion transaction value	June 14, 1999	July 27, 1999	1+ month	• EC approval July 26, 1999.

No.	Principal Merging Entities	Market Value (approximate)	Announcement Date	Completion Date	Total Time	Procedural History & Relevant Factors
7	Ascend Communications Inc./ Lucent Technologies Inc.	$24 billion transaction value	January 13, 1999	June 24, 1999	5+ months	• DOJ requests additional information March 9, 1999; • DOJ and EC approval April 12, 1999.
8	BankAmerica Corporation/ NationsBank Corporation	$45 billion transaction value; $570 billion combined assets	April 13, 1998	September 30, 1998	5+ months	• Divestiture agreement with DOJ clears merger August 14, 1998; • FRB approval August 17, 1998; • Shareholder approval September 24, 1998.
9	BankBoston/ Fleet Financial Group	$16 billion transaction value; $180 billion combined assets	March 14, 1999	October 1, 1999	6+ months	• Shareholder approval August 11, 1999; • Divestiture agreement with DOJ clears merger September 2, 1999; • FRB approval September 7, 1999; • Massachusetts Board of Bank Incorporation approval September 30, 1999.
10	Barnett Banks, Inc./ NationsBank Corporation	$14.6 billion transaction value; $310 billion combined assets	August 29, 1997	January 9, 1998	4+ months	• Divestiture agreement with DOJ clears merger December 9, 1997; • FRB approval December 10, 1997; • Shareholder approval December 19, 1997.
11	Beneficial Corp./ Household International	$8.6 billion transaction value	April 7, 1998	June 30, 1998	2+ months	• FTC grants early termination of HSR Act waiting period May 15, 1998.

No.	Principal Merging Entities	Market Value (approximate)	Announcement Date	Completion Date	Total Time	Procedural History & Relevant Factors
12	Boatmen's Bancshares Inc./ Nationsbank Corp.	$9.8 billion transaction value; $233 billion combined assets	April 30, 1996	January 7, 1997	8+ months	• FRB approval December 16, 1996.
13	Case Corporation/New Holland N.V.	$6 billion transaction value	May 17, 1999	November 12, 1999	5+ months	• Shareholder approval August 17, 1999; • EC approval October 28, 1999; • DOJ approval November 4, 1999.
14	Chrysler Corporation/ Daimler-Benz AG	$92 billion transaction value	May 7, 1998	November 12, 1998	6+ months	• EC approval July 23, 1998; • FTC approval July 31, 1998; • Shareholder approval September 18, 1998.
15	Citicorp/ Travelers Group Inc.	$140 billion transaction value; $300 billion combined assets	April 6, 1998	October 8, 1998	6+ months	• DOJ approval (date unavailable); • Shareholder approval July 22, 1998; • FRB conditional approval September 23, 1998.
16	Corestates Financial Corp./ First Union Corp.	$16.6 billion transaction value; $220 billion combined assets	November 18, 1997	April 27, 1998	5+ months	• Shareholder approval February 27, 1998; • Divestiture agreement with DOJ clears merger April 10, 1998; • FRB approval April 13, 1998.

No.	Principal Merging Entities	Market Value (approximate)	Announcement Date	Completion Date	Total Time	Procedural History & Relevant Factors
17	Crestar Financial Corporation/ SunTrust Banks, Inc.	$8.3 billion transaction value, $87 billion combined assets	July 20, 1998	December 31, 1998	5+ months	• FRB approval October 28, 1998; • Shareholder approval December 23, 1998.
18	First Chicago NBD Corporation/ Banc One Corporation	$29 billion transaction value; $279 billion combined assets	April 13, 1998	October 2, 1998	5+ months	• FRB public meeting August 13, 1998, • Divestiture agreement with DOJ clears merger September 8, 1998; • FRB approval September 14, 1998; • Shareholder approval September 15, 1998.
19	Frontier Corporation/ Global Crossing Ltd.	$30 billion combined assets; $11.2 billion transaction value	March 17, 1999	September 28, 1999	6+ months	• New York Public Service Commission approval September 17, 1999; • FCC approval September 21, 1999; • Shareholder approval September 22,1999.
20	General Re Corp./ Berkshire Hathaway Inc.	$22 billion transaction value	June 19, 1998	December 21, 1998	6+ months	• FTC grants early termination of HSR Act waiting period October 15, 1998.

No.	Principal Merging Entities	Market Value (approximate)	Announcement Date	Completion Date	Total Time	Procedural History & Relevant Factors
21	GTE Corp./ Bell Atlantic	$53 billion transaction value	July 28, 1998	June 16, 2000	22+ months	• Application filed with FCC October 2, 1998; • State entities approval process March 16, 1999 – March 2, 2000; • Divestiture agreement with DOJ clears merger May 7, 1999; • Shareholder approval May 18, 1999; • FCC consideration suspended April 14, 1999 per applicants' request; • Application supplement to FCC January 27, 2000; • FCC called for public comments re: applicants' subsequent filings April 28, 2000; • FCC conditional approval June 16, 2000.
22	HBO & Co./ McKesson Corp.	$12 billion transaction value	October 18, 1998	January 12, 1999	2+ months	• Waiting period expired under HSR Act November 30, 1998; • Shareholder approval January 12, 1999.
23	HFS Incorporated/ CUC International Inc.	$8.7 billion transaction value	May 27, 1997	December 18, 1997	5+ months	• Divestiture agreement with FTC clears merger December 17, 1997.
24	Honeywell Inc./ AlliedSignal Inc.	$14 billion transaction value; $24 billion combined assets	June 7, 1999	December 1, 1999	5+ months	• DOJ requests additional information July 26, 1999; • EC enters Phase II of DOJ review August 30, 1999; • Applicants & DOJ reach divestiture agreement in principle October 4, 1999; • DOJ clearance November 8, 1999; • EC clearance December 1, 1999.
25	Hughes Electronics Corporation/ Raytheon Company	$9.5 billion transaction value	January 16, 1997	December 18, 1997	11+ months	• Divestiture agreement with DOJ clears merger October 2, 1997.

No.	Principal Merging Entities	Market Value (approximate)	Announcement Date	Completion Date	Total Time	Procedural History & Relevant Factors
26	ITT Corporation/ Starwood Hotels & Resorts Worldwide	$13.3 billion transaction value	October 20, 1997	February 24, 1998	4+ months	• FTC grants early termination of HSR Act waiting period December 4, 1997; • Shareholder approval February 13, 1998; • State regulatory approval February 20, 1998.
27	McDonnell Douglas/ Boeing Co.	$13.3 billion transaction value	December 15, 1996	August 1, 1997	7+ months	• EC statement of objections to merger May 21, 1997; • FTC unconditional approval July 1, 1997; • Shareholder approval July 25, 1997; • EC final approval July 30, 1997.
28	MCI/ World Com	$44 billion transaction value	November 10, 1997	September 14, 1998	10+ months	• Application filed with FCC October 1, 1997; • EC continues review March 4, 1998; • Shareholder approval March 11, 1998; • Divestiture agreement with DOJ clears merger July 15, 1998; • FCC approval September 14, 1998; • EC final approval (date unavailable).
29	Mobil Corporation/ Exxon Corporation	$75 billion transaction value	December 1, 1998	December 1, 1999	12 months	• Pre-Merger Notification filed with EC May 3, 1999; • Shareholder approval May 27, 1999; • EC second phase inquiry opened June 9, 1999; • EC approval September 29, 1999; • Divestiture agreement with FTC clears merger November 30, 1999.
30	Morgan Stanley Group Inc./ Dean Witter, Discover & Co.	$10 billion transaction value	February 5, 1997	May 31, 1997	3+ months	• Shareholder approval May 28, 1997.

No.	Principal Merging Entities	Market Value (approximate)	Announcement Date	Completion Date	Total Time	Procedural History & Relevant Factors
31	Netscape Communications Corporation/ America Online, Inc.	$4.2 billion transaction value	November 24, 1998	March 17, 1999	3+ months	• DOJ approval March 12, 1999.
32	Network Solutions, Inc./ Verisign, Inc.	$21 billion transaction value	March 7, 2000	June 9, 2000	3+ months	
33	Nynex Corp./ Bell Atlantic Corp.	$25.6 billion transaction value	April 22, 1996	August 14, 1997	15+ months	• Shareholder approval November 1996; • State entities approval January 1997 through April 1997; • DOJ approval April 24, 1997; • Applicants propose mitigating commitments to FCC July 19, 1997; • FCC conditional approval August 14, 1997.
34	PacifiCorp/ ScottishPower	$7.9 billion transaction value	December 7, 1998	November 30, 1999	11+ months	• Early termination of HSR Act waiting period February 16, 1999; • State entities approval January 1999 through November 1999; • UK regulatory clearance April 13, 1999; • FERC approval June 17, 1999; • Shareholder approval June 18 & 19, 1999; • Nuclear Regulatory Commission approval November 12, 1999.
35	Pacific Telesis Group/ SBC Communications, Inc.	$16.5 billion transaction value	April 1, 1996	April 1, 1997	12 months	• DOJ approval November 5, 1996; • FCC approval January 28, 1997; • State entities approval December 1996 through March 1997.

No.	Principal Merging Entities	Market Value (approximate)	Announcement Date	Completion Date	Total Time	Procedural History & Relevant Factors
36	Pioneer Hi-Bred International Inc./ DuPont	$7.7 billion transaction value	March 15, 1999	October 1, 1999	6+ months	• Applicants agree to give DOJ additional time to complete its initial review April 22, 1999; • DOJ approval May 21, 1999; • EC approval June 21, 1999; • SEC approval August 31, 1999; • Shareholder approval October 1, 1999
37	SBC Communications/ So. New England Tele.	$6.5 billion transaction value	January 5, 1998	October 23, 1998	10+ months	• Connecticut regulators approval September 3, 1998; • DOJ approval (date unavailable); • FCC approval October 23, 1998.
38	SunAmerica Inc./ American International Group, Inc.	$18 billion transaction value	August 20, 1998	January 1, 1999	4+ months	• SEC approval October 8, 1998; • Shareholder approval November 18, 1998.
39	Tele-Comm. (TCI)/ AT&T Corp.	$48 billion transaction value	June 24, 1998	March 9, 1999	8+ months	• Application filed with FCC September 14, 1998; • Divestiture agreement with DOJ clears merger December 30, 1998; • FCC approval February 18, 1999.
40	Teleport Comm. Group (TCG)/ AT&T Corp.	$11.3 billion transaction value	January 8, 1998	July 23, 1998	6+ months	• Application filed with FCC February 3, 1998; • FCC approval July 23, 1998.
41	Transamerica Corporation/ AEGON NV	$9.7 billion transaction value	February 18, 1999	July 21, 1999	5+ months	• FTC grants early termination of HSR Act waiting period March 30, 1999; • June 7, 1999 approved by EC; • June 18, 1999 approved by SEC.
42	Travelers Group/ Salomon Inc.	$9 billion transaction value	September 24, 1997	November 28, 1997	2+ months	

No.	Principal Merging Entities	Market Value (approximate)	Announcement Date	Completion Date	Total Time	Procedural History & Relevant Factors
43	U.S. Bancorp/ First Bank System, Inc.	$9 billion transaction value; $72 billion combined assets	March 20, 1997	August 1, 1997	4+ months	• FRB approval June 23, 1997; • Shareholder approval July 31, 1999.
44	US West/ Qwest Communications	$42 billion transaction value	July 18, 1999	June 30, 2000	11+ months	• Application filed with FCC & state entities August 19, 1999; • DOJ approval August 12,1999; • SEC approval August 13, 1999; • Shareholder approval November 2, 1999; • State entities approval January 7, 2000 through June 2000; • FCC approval March 10, 2000.
45	Warner-Lambert Co./ Pfizer Inc.	$90 billion transaction value	February 7, 2000	June 19, 2000	4+ months	• EC approval May 22, 2000; • FTC grants early termination of HSR Act waiting period June 19, 2000.
46	Waste Management, Inc./ USA Waste Services, Inc.	$13.5 billion transaction value	March 11, 1998	July 16, 1998	4+ months	• Shareholder approval July 15, 1998; • Divestiture agreement with DOJ and state entities clear merger July 16, 1998.
47	WebMD, Inc./ Healtheon Corp./ (& MEDE America Corp. & Medcast Networks)	$10 billion transaction value (Healtheon & WebMd)	May 20, 1999 (Healtheon & WebMD)	November 11, 1999	5+ months	• Merger with MEDE America Corp. announced April 21, 1999; • MedCast Networks merger announced July 1, 1999.

No.	Principal Merging Entities	Market Value (approximate)	Announcement Date	Completion Date	Total Time	Procedural History & Relevant Factors
48	Wells Fargo & Company/ Norwest Corporation	$34 billion transaction value; $196 billion combined assets	June 8, 1998	November 2, 1998	4+ months	• Divestiture agreement with DOJ clears merger October 13, 1998; • FRB approval October 14, 1998.

CERTIFICATE OF SERVICE

I do hereby certify that copies of The Burlington Northern and Santa Fe Railway Company's Comments are being served on all parties of record this 17th day of November, 2000.

David I. Bloom

BEFORE THE
SURFACE TRANSPORTATION BOARD

EX PARTE NO. 582 (SUB-NO. 1)

MAJOR RAIL CONSOLIDATION PROCEDURES

VERIFIED STATEMENT
OF
ROBERT D. KREBS

I am Robert D. Krebs, Chairman and Chief Executive Officer of Burlington Northern Santa Fe Corporation, which owns and operates The Burlington Northern and Santa Fe Railway Company ("BNSF"). A summary of my background is attached as an appendix to this statement.

The Board has proposed numerous changes to its rail merger policies. Many of these changes make sense in today's environment, and I have addressed many of the sensible proposals in previous statements and testimony in this and related proceedings. In this statement, I want to address several major issues raised by the proposed rules that could adversely affect the rail sector's ability to attract investment capital.

In an earlier decision in a related proceeding, the Board concluded:

> "Looking forward, the key problem faced by railroads — how to improve profitability through enhancing the service provided to their customers — is ***linked to adding to insufficient infrastructure***, not to eliminating excess capacity." STB Ex Parte No. 582 Decision (March 17, 2000), page 6. (Emphasis added).

The Board was correct in this observation. I believe that the greatest challenges facing the railroad industry and its customers today are (1) the challenge of improving service to rail shippers and (2) the challenge of attracting the capital investment needed to obtain efficiencies from the existing rail infrastructure and, where necessary, to construct new infrastructure to support improved rail service offerings. Given the fact that the rail sector lags behind other industry sectors in growth and return on invested capital, it is already challenging to attract investment capital to the rail sector. Moreover, investor focus on short-term profits does not reward companies that make investments in the long-term infrastructure improvements that will be needed to improve service and handle additional capacity. Therefore, if the Board is serious about encouraging improvements in rail service, it should ensure that its policies do not discourage private investment in the rail sector and that its policies affirmatively encourage adequate revenues for rail businesses.

A vitally important factor to investors in today's economic climate is the speed with which they will see an appropriate return on their investments. When regulatory approvals are required for transactions, investors need predictable and expeditious outcomes. To avoid discouraging investment in the rail sector, the Board must accelerate its merger review process to reach quickly the core issues that need to be addressed in a rail merger. The lengthy proceedings permitted (but not required) under the statute, coupled with the vague new standards identified in the proposed rules, could chill a good merger proposal from even being made. To prevent that result, and to assure investors that the Board is sensitive to the need for expeditious decisionmaking, the Board should adopt a pro forma procedural schedule that permits full public participation and environmental review, yet results in a final Board decision within one year of the parties' filing of a notice of intent.

As I noted above, the proposed new merger policy appropriately addresses many of the needs of today's transportation market. For example, the proposal to require the preparation of detailed Service Assurance Plans to accompany future merger applications is an excellent idea that should aid the agency and the public in reviewing whether the merger applicants will be able to deliver adequate service in the post-merger environment. I also support the Board's proposal to ensure that major gateways remain open following a merger, that the "contract exception" right is maintained, and that build-in and transload opportunities are preserved for shippers.

In many other respects, however, the proposed new merger policy introduces serious new risks of delay and uncertainty into the regulatory process, signaling investors that the rail sector may be an unpredictable market in the foreseeable future. On a related point, by adopting a presumption that future mergers are inherently harmful and making it more difficult to justify future mergers, the proposed new merger policy signals investors that the Board is satisfied with the status quo of rail sector financial performance and capital investment.

I am not satisfied with the status quo of rail sector financial performance. I believe that there are substantial opportunities for growth in the rail sector. These opportunities will not come to pass, however, if the industry cannot improve its ability to attract investment capital. Unfortunately, the proposed new merger policy is a step in the wrong direction, and will make it harder, rather than easier, for the rail industry to attract the capital it needs to fulfill the Board's vision of improved service to rail shippers.

I therefore intend to address the following points in detail in this statement.

First, there is no reason to delay the benefits of a good merger for shippers. Yet, extended procedural schedules defer those benefits for shippers and can even lead to the complete loss of those benefits because good mergers are either not proposed or are undone by the delay and uncertainty of the review process. Second, during the period when a merger is pending before the Board, the applicants and other parties are placed in a regulatory limbo, unsure how to plan for the future or how to respond to other opportunities. Third, capital markets cannot tolerate uncertainty or delay. The mere threat of an extended regulatory proceeding would cause capital to seek other investment opportunities and place downward pressure on railroad stocks. I believe that the proposed new merger policy statement does not adequately consider this issue, and I will urge that the Board adopt a policy committing to an expeditious review of any proposed rail merger in the future.

I also will suggest that the new policy inappropriately presumes that future rail merger proposals are inherently harmful, a presumption that will strongly discourage future investment in the rail sector. I will urge the Board to revisit this presumption, as well.

The Public Interest Requires More Expeditious Consideration of Railroad Merger Applications

In citing some of the tenets of the Rail Transportation Policy in support of its proposed new merger policy, the Board overlooked one provision of the Policy that is extremely important to investors: the Rail Transportation Policy's call for "fair and expeditious regulatory decisions."

Delay is the enemy of capital investment. Investors are not ordinarily willing to park their investment dollars awaiting lengthy regulatory approvals of a transaction. Investors make an exception when they perceive that a transaction will add value to the investment in the long run, but only when the regulatory process is expeditious and predictable. In connection with our recent proposal to combine with the Canadian National Railway Company ("CN"), our investors made it clear to us that they could not tolerate the additional delay that was introduced by the Board's moratorium, coupled with the already lengthy regulatory review process. Because our two companies could not risk the flight of investment capital that would likely have resulted from waiting for the moratorium and approval process to run their courses, we jointly terminated the transaction this summer, notwithstanding the significant shipper benefits that could have resulted from that proposed combination.

There is no other U.S. industry that must routinely endure merger approval processes that are as lengthy and expensive as the Board's merger review process. To be sure, there are isolated examples of transactions that have become embroiled in lengthy regulatory reviews, but these are rare. Far more commonly, federal regulatory clearances for major mergers — including transactions far larger in value than any modern rail merger — occur in a matter of a few months. And, it would be parochial (and wrong) to presume that mergers in other industries have less significant effects on the U.S. economy than end-to-end rail mergers. Recent consolidations in the banking, telecommunications and energy sectors have dwarfed recent rail mergers, and have reshaped markets in many industrial sectors.

There is simply no public policy justification for stretching out railroad merger reviews to nineteen months (or longer). Mergers in other industries do not require protracted evidentiary proceedings, depositions or environmental reviews. While I understand that the Board could not eliminate all of the procedures now required, there are many steps (such as interrogatories and depositions) that are not required by the statute and add substantial delay and expense to the process. The Board could retain each of the rail merger procedural steps mandated by the statute, as well as complete an environmental review, and still complete the evidentiary portion of the case within six months after an application is filed. BNSF's comments contain a template for a 270-day procedural schedule that provides ample opportunities for public participation, environmental review and Board consideration, allowing a decision to be rendered within nine months of the filing of an application. There is simply no reason why the entire merger review process could not be completed by the Board quickly enough to permit closing of an approved transaction within one year of the parties' filing their notice of intent to apply for merger approval.

The bottom line is that shareholders and shippers alike suffer when they must defer enjoyment of the benefits accruing from a beneficial rail merger until the conclusion of the lengthy STB review process. The delays inherent in the current process are a severe deterrent to investors and deprive shippers of the improved services, transit times and other benefits that can accompany end-to-end rail mergers. The Board should reexamine its procedural rules, eliminate unnecessary steps and commit publicly to a streamlined, expedited review of future rail merger proposals in order to remove a significant obstacle to investment in the rail sector.

It is Wrong to Presume that All Remaining Potential Mergers in the Rail Sector Are Inherently Harmful

The Notice of Proposed Rulemaking proposes to create a new presumption that any future rail mergers will be inherently harmful to competition and rail service (at least temporarily) and proposes to require future merger applicants to come up with a plan to "enhance" competition as a way of mitigating against these perceived harms.

This new presumption ignores the fact that modern rail mergers have made railroads more effective competitors, thereby improving the competitive marketplace served by all modes of transportation. Shippers have benefitted from this improved competitive market through lower rates, better service and innovative service offerings.

If we had been allowed to file our application for review of the proposed combination of BNSF and CN, it would have shown how the combination would have advanced the public interest in many ways. These included offering shippers improved routing options, faster transit times on major routes, bypassing congested urban areas and providing unprecedented gateway and service guarantees. Our proposed combination would have produced improved asset utilization, thus increasing the capacity of the combined system without the need for additional equipment and infrastructure investment. The combination would also have yielded substantial economic synergies, freeing capital for infrastructure investment where that investment may be needed; and it would have substantially advanced the interests of North American trade as embodied in the North American Free Trade Agreement ("NAFTA"). We believe we would have shown that these public interest benefits were achievable without introducing competitive harm, without adverse effects on employee or public safety, and with only minimal effects on employment or the environment.

The application would have described estimated total merger benefits of approximately $800 million annually, including over $300 million in additional net revenue from traffic gains, a substantial portion of which came from attracting business back to the rail system. We also projected approximately $500 million in operating synergies per year, of which $400 million would have been reduced operating costs and $100 million in avoided capital expenditures. These savings would have made the combined railroads even stronger financially, better able to compete for new business and make infrastructure investments. Even more important, the new system would have provided owners with returns in excess of the company's cost of capital. Unless and until we can earn our cost of capital, BNSF's ability to make infrastructure and equipment investments is questionable. Indeed, we may find that further consolidation is necessary to assure the rail industry's financial health for the benefit of its customers, employees and the country.

Therefore, there is absolutely no basis for the proposed new presumption and no reason to saddle future mergers with the substantial costs of "enhancing" competition. What it means to "enhance" competition is not precisely spelled out, but the proffered examples all have one thing in common: the merging carriers would have to open up some amount of business to new competition without receiving any counterpart access to new customers from the other rail carriers. Unlike existing merger policy, which ensures the preservation of two carrier service for shippers that enjoyed that competition before the merger, the new presumption and remedy proposal would bestow new competition on shippers that do not now have any rail-to-rail competition.

I know of no other U.S. industry that is expected to give away its customers without compensation as a condition of obtaining federal approval to merge. This proposal is particularly ill-advised, because the "enhanced" competition is not required to be related to the specific alleged harm and there is therefore no way for an applicant to know what level of enhancements will be required by the Board as a condition of approval. The net effect of this new presumption of harm, and mandated remedy is to increase the costs of future mergers, while providing a windfall to the rail carriers that are not among the first to merge under the new policy. This will make it much more difficult to persuade investors to support future mergers, and will likely result in deterring beneficial mergers that would have passed muster under the existing merger policy. Shippers will suffer the loss of merger-related efficiencies and benefits that they would have enjoyed from mergers that are discouraged by the proposed new policy.

The Board's proposal cannot be reconciled with the public interest. Notwithstanding the serious service disruptions that followed the Union Pacific/Southern Pacific merger, no one could seriously suggest that rail shippers would be better served today with an independent (but financially crippled) Southern Pacific. Yet, it is unlikely that any carrier would have been willing to take on the problems and expense of rebuilding the Southern Pacific franchise if it also had to "enhance" competition as a price of obtaining federal approval to merge.

Moreover, this proposal puts the Board in the role of central planner for the railroad industry, by deciding which shippers will benefit from enhanced competition and which will not. This proposal is a giant step toward reregulation that itself will discourage future investment in the rail sector, as the Board was clearly told at its public hearings in March 2000 in a proceeding related to this rulemaking.

I also want to comment on the proposal to require applicants to prove during the oversight proceedings that they have actually achieved the projected benefits of the merger. This proposal completely misses the point of a dynamic marketplace — shippers can benefit from competitive responses to mergers that may deprive the merging parties of the expected traffic, but which in fact produce lower rates or better service for shippers. Such a result cannot be considered harmful to the public interest, and no intervention from the Board should be needed to address the failure of merging carriers to gain as much new traffic as they had hoped to gain. Moreover, it is unclear what remedies are available to the Board in such a circumstance.

Finally, I want to comment on the proposal to require applicants to accept the possibility of indeterminate conditions that may be imposed years after the merger in order to address some perceived harm arising from a ***future*** consolidation. Such a new requirement would impose unacceptable uncertainty on the first carriers to merge under the new policy. Investors could not possibly evaluate the economics of a transaction that has no finality and that could be converted, retroactively, from a beneficial transaction to an economically unattractive one. This concept is anathema to investors and will seriously harm the industry's ability to attract investment capital in the future.

Conclusion

If the Board wants rail service improvements, it must establish policies that encourage, rather than discourage, investment in the rail sector to finance those improvements. The Board's proposed new merger policy sends the wrong signals to the capital markets about the likelihood of damaging reregulation. Moreover, the proposed policy would increase the costs of mergers, perhaps to the point of making them economically infeasible, sending yet another negative signal to the capital markets. Finally, the proposed policy misses the opportunity to streamline and expedite the rail merger approval process, an essential step if railroads are to compete effectively for investment capital with other industries that enjoy much swifter reviews of their merger proposals.

ROBERT D. KREBS
CHAIRMAN AND CHIEF EXECUTIVE OFFICER

A native of Sacramento, California, Mr. Krebs began his career in the railroad industry when he joined the Southern Pacific Company in June of 1966 on special duty in the operating departments of Southern Pacific Transportation Company ("SPT") and the St. Louis Southwestern Railway Company, becoming Vice President-Operations of SPT in 1980; a Director of SPT in 1981; President of SPT and St. Louis Southwestern Railway Company in 1982; President and Chief Operating Officer of Santa Fe Southern Pacific Corporation ("SFSP") in 1983; President and Chief Executive Officer of SFSP in 1987; Chairman, President and Chief Executive Officer of SFSP on May 24, 1988; Chairman and Chief Executive Officer of The Atchison, Topeka and Santa Fe Railway Company ("ATSF") on June 1, 1989; and Chairman, President and Chief Executive Officer of ATSF on June 4, 1991.

On September 22, 1995, he was named President and Chief Executive Officer of Burlington Northern Santa Fe Corporation. On April 17, 1997, he was named Chairman, President and Chief Executive Officer of Burlington Northern Santa Fe Corporation. On June 1, 1999, he was named Chairman and Chief Executive Officer of Burlington Northern Santa Fe Corporation and Chairman and Chief Executive Officer of The Burlington Northern and Santa Fe Railway Company.

Mr. Krebs earned a Bachelor of Arts degree at Stanford University in 1964. He graduated with distinction and was elected to Phi Beta Kappa. He earned a Master of Business Administration at the Harvard Graduate School of Business in 1966.

VERIFICATION

I, Robert D. Krebs, verify under penalty of perjury under the laws of the United States that the foregoing is true and correct. Further, I certify that I am qualified and authorized to file this Verified Statement.

Executed on November 16, 2000.

Robert D. Krebs

BEFORE THE
SURFACE TRANSPORTATION BOARD

STB EX PARTE NO. 582 (Sub-No. 1)
PUBLIC VIEWS ON MAJOR RAIL CONSOLIDATIONS

VERIFIED STATEMENT OF
JOSÉ A. GÓMEZ-IBÁÑEZ
AND
JOSEPH P. KALT[1]

I. INTRODUCTION

The railroad industry is a vital part of the modern US economy, fulfilling a critical role in keeping the nation's logistics system efficient and competitive in today's global economy. Accordingly, the public has an important stake in ensuring that the industry is structured and regulated in ways that provide the benefits of a well-functioning rail sector. The restructuring of the rail sector and the framework of governmental oversight employed over the last twenty-five years have helped to bring the sector to the point where it is now clearly a strong contributor to, rather than an anachronistic drag on, the nation's business. Mergers and related ownership restructurings have played significant and, on net, positive roles in the industry's turnaround.

Given the stake that the public has in a healthy and efficient rail system, and given problems of service disruptions that have followed on the heels of some recent consolidations, it is appropriate that policymakers now address the questions of whether and how merger policy might be /improved. The current proposals of the Surface Transportation Board provide the opportunity to appropriately focus public discussion. The Board has solicited comments on the need for policy changes and received voluminous responses from

[1] José Gómez-Ibáñez is the Derek C. Bok Professor of Public Policy and Urban Planning at Harvard University's John F. Kennedy School of Government and Graduate School of Design in Cambridge, Massachusetts. He has served as the faculty chair of the Public Policy Program at the Kennedy School and the chair of the Department of Urban Planning and Design at the Graduate School of Design. In addition, Gómez-Ibáñez has served as a consultant to governments and international lending agencies on infrastructure privatization and regulation. Joseph P. Kalt is the Ford Foundation Professor of International Political Economy at the John F. Kennedy School of Government at Harvard University in Cambridge, Massachusetts. At the Kennedy School, he has served as chair of the economics and quantitative methods cluster, faculty chair and Academic Dean for Research, chair of degree programs, and chair of the Ph.D. program. In addition, he works as a senior economist with Lexecon Inc. Attachment 1 provides information on the authors' professional and academic backgrounds.

railroads, shippers, and other interested parties. In our view, the resulting proposed rules constitute a mixed picture, holding promise for improving merger policy in key dimensions, but risking harm to the nation's economic health in others.

On the promising side, the Board's efforts to protect against merger-related service disruptions in its proposed rules are both well-timed and consistent with principles of sound public policy. Until the recent UP/SP merger, the railroad industry and its regulators arguably had underestimated the transitional problems that mergers could pose. The UP/SP experiences, followed by implementation difficulties attendant to the breakup of Conrail, have driven home the lesson that mergers, consolidations, and restructurings can adversely affect service not only on the merging carriers' systems, but on connecting carriers as well. Consequently, rail industry stakeholders nationwide—including the Board, the railroads, shippers, and the general public—have a vital interest in ensuring that such service disruptions do not recur. The present proceeding provides the Board with a valuable opportunity to make substantive improvements to its merger policy so as to minimize the prospects of future merger-related service disruptions.

On the dangerous side, the analysis of the competitive implications of mergers and consolidations in the proposed rules oversteps the traditional and appropriate role of merger review and opens unnecessarily a Pandora's box of political temptations and difficulties. In particular, we are troubled by the proposals to require (1) that a proposed merger not only protect, but enhance, competition, (2) that merging railroads demonstrate that the benefits they seek can not be achieved by any other means short of consolidation, (3) that merging parties analyze the effects of future consolidations that the merger in question might provoke, and (4) that they provide specific guarantees of the benefits that consolidation will provide.

As the Board notes, these features of its proposed new rules constitute a "paradigm shift" in merger policy. Stated bluntly, the Board appears to have concluded that future railroad mergers are unlikely to be in the public interest, and, based on this conclusion, the Board has proposed a set of rules that would do much to discourage future rail mergers. Indeed, it is notable that these proposed rules are not just more restrictive than the rules the Board has applied to railroads in the past, but are far more restrictive than the tests that anti-trust regulators generally apply to other industries.

While the Board's concern with service disruptions is warranted, we believe that the competition-related elements of the proposed rules will effectively act as an unnecessary and harmful "tax" on efficient merger transactions, raising risks and other costs faced by future merger applicants. The proposed requirement that mergers enhance competition is a clear example of this. The test commonly applied by the Board to prior railroad mergers (and by other regulators to their industries) has evolved into a standard of "do no harm to competition." Where there is a risk of reduced competition, Board precedent now clearly compels merger applicants to pre-condition their transaction with remedies if a consolidation is to have any chance of being approved by the Board. In practice, this is a strict test in that it does not admit to the possibility that even small reductions in competition might be tolerable if a merger's benefits (in improved railroad efficiency or service) were sufficiently large. Effectively, current policy holds that mergers are disallowed unless competition is protected, regardless of the other benefits that might be achieved. To now go further and require that a merger enhance competition would result in the discouragement and denial of mergers that do not harm competition and do provide other public benefits. Worse, the requirement to enhance competition is so open ended that it will empower intervenors to "hold up" merger applicants for concessions that are completely unrelated to the specific competitive or other concerns a merger raises. In short, it is an invitation to politicize the merger review process.

Indeed, we fear that some of the proposed rules have less to do with the evaluation of whether a proposed merger is in the public interest than with an effort to overturn the reforms to railroad regulation ushered in under the Staggers Act of 1980. The Staggers Act led to a dramatic revival of the railroad industry that benefits both railroads and shippers alike. After decades of minimal returns and decaying service, railroad profitability finally improved to the point where major new investments could be financed from private capital markets. Improvements in railroad efficiency made possible dramatic reductions in average railroad rates, enhanced service reliability, and a resurgence in railroad traffic. Mergers and consolidations were key tools the industry used to reduce costs and improve service in the Staggers era. Effective merger policies should not now be abandoned in misguided attempts to respond to shifting political winds. Merger policy should be improved where it has failed to adequately protect the *public* interest.

II. THE LOGIC OF CURRENT MERGER POLICY

II.A The Board's Current Merger Policy

In its current merger policy, as implemented in recent merger reviews, the Board has focused the bulk of its resources on addressing the protection of competition. In particular, the Board has required that merger applicants identify every case where a merger would cause a shipper to lose a meaningful competitive option and take steps to remedy that loss.

The Board's current merger policy is, in fact, more restrictive than seems to be required under the Staggers Act. The Staggers Act provides that the Board apply a "net public benefits" test. That is, the Board is to weigh the possible benefits of a merger against its potential costs, and to determine whether the public would be, on the whole, better off with the merger or not. The benefits might include reductions in railroad costs or improvements in railroad service, while the costs might include reduced competition and service disruptions during the transition. In practice, however, the merger review process devotes relatively little attention to merger benefits, in effect applying a test that a merger must impose little or no costs, regardless of its benefits. [2]

II.B The Focus on Protecting Competition

The Board's vigilant attention to protecting competition puts it in the "mainstream" of merger and antitrust policy as it is practiced in other industries. Mergers, like most business conduct in a private enterprise economy, are motivated by private gain to the decision-making parties. Such gain can result from all sorts of causes, many of which generate public benefits. Of course, one source of potential private gain not in the public interest arises if a merger might create or enhance the use of market power. For this reason, while our economic system properly gives wide berth to private incentives, merger policy, broadly applied, is properly concerned with protecting competition. This holds even in non-regulated industries, where the harm to competition and the risk of the exercise of market power is the primary focus of merger policy.[3]

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[2] The Staggers Act calls for the Board to consider a number of factors, such as the effect on labor and the environment as part of the merger review process.

[3] See *Horizontal Merger Guidelines*, U.S. Department of Justice and the Federal Trade Commission, April 2, 1992 as amended April 8, 1997.

Economic analysis provides the tools for analyzing competition and the risk that a merger will enhance market power. Market power, either unilateral or in conjunction with other firms, is the ability to maintain prices above competitive levels. When firms that compete in a market merge, the merger reduces the number of competitors in that market. Depending on the facts and circumstances of the merger, this reduction in competitive rivalry between the merging parties may reduce competition and present a significant risk of competitive harm through the prospective use of market power. Factors such as concentration, entry, and ease of engaging in coordinated anticompetitive action need to be evaluated.

By focusing primarily on preventing harm to competition, traditional merger policy recognizes that it is important to establish appropriate boundaries between private and public decision making. The government has a legitimate role in ensuring that mergers do not harm the public, primarily through the loss of competition. But there is a concomitant need to ensure that regulatory policy does not kill off private incentives to seek efficient and high quality business strategies. Individual companies are in a much better position than the government to understand the intricacies of the industry and customer needs so as to efficiently organize business activities and capital investment.

In short, sound merger policy, as has been generally implemented across other industries, is properly focussed on ensuring specific public policy interests are preserved—such as the protection from the exercise of market power. To the extent these policy objectives are met, private companies are properly free to risk their capital and make their investments as they see fit. Failure to heed these principles is a recipe for counter-productive policies when it comes to serving the public interest.

II.C The Application of Merger Policy to Railroads

This standard approach of protecting competition has been applied to the railroad industry in a fairly straightforward way by the Surface Transportation Board in the past. The Board has examined proposed mergers on a case-by-case basis, using the tools of economic analysis to assess the risk of competitive harm. In many, many situations in the railroad industry, a merger poses no threat to competition because it does not even alter the number of railroads that particular shippers have access to at their particular shipping points. Moreover, even where a rail merger might reduce the number of rail alternatives, intermodal, geographic and source competition all can serve to limit the potential exercise of market power. Applying these tests to a particular proposed rail merger depends on the facts and circumstances of that merger and the specific markets in which the merging railroads are found to compete. The de facto standard that has emerged from recent merger cases is that the evidence presented to the Board must demonstrate that a merger will not reduce the number of independent rail options serving a shipper to less than two, regardless of the extent of alternative competitive options from other sources.[4] Where a merger would reduce the number of rail alternatives, for example, from three to two, additional factual inquiry appropriately ensues.

One difference between the railroads and most other industries, however, is that merger oversight is not the only protection against railroad market power. Unlike most of the U.S. economy, the rail industry is subject to economic regulation. This arises, in part, because some shippers are served by a single railroad. As a result of the economies of density, scale and scope in the rail industry, most rail shippers will not have (and never have had) a choice of numerous independent rail transportation alternatives. And while much rail traffic is subject to intense competition from trucks, barges or other sources, some shippers will have few if any competitive alternatives to the one railroad serving them. The existing regulatory structure incorporates this reality and provides protections to captive shippers through oversight and capping of rates, while at the same time providing the possibility (but

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[4] The Board has applied the same standard to potential rail competition in the form of preserving build-in and build-out opportunities.

not the assurance) of railroads being able to earn a sufficient return to support the fixed and common costs of the rail infrastructure.

Over the years, the system of economic regulation has had to learn the importance of striking an appropriate balance between protecting captive shippers and railroad financial health. Railroads typically have fixed and network costs that are very high while their variable costs for moving any particular shipment are often very low. One of the chronic problems of the railroad industry is that services that are subject to intense intra- or intermodal competition seldom make any significant contributions to those high fixed or variable costs. If the railroad is to avoid bankruptcy, it must raise these contributions from those services where competition is not as intense. The Staggers Act of 1980 explicitly recognized this problem by granting the railroads the right to charge different shippers different prices but within specified limits. In doing so it both protected captive shippers (by capping their prices) and the railroads' viability (by allowing them rate flexibility).

The Staggers Act does not conflict with the traditional merger policy of protecting against competitive harm. Indeed, the Act supplements merger review by providing an additional layer of protection for shippers who have few competitive options. But the wisdom of the Staggers Act is that it recognizes the reality that competition is unlikely to be extremely intense on every service, and that if it ever were the railroad industry would be forced into financial decline or required to seek public subsidy. In other words, maintaining some modest market power and differential pricing, within strictly regulated limits, is in the long-term interests of shippers.

A second difference between the railroads and most other industries is that harm to competition is not the only major potential public cost of mergers. In particular, railroads connect with one another and exchange traffic, so that service disruptions caused by the merger of two carriers can affect other carriers in the industry. The merging carriers may not consider the costs of the disruptions caused on other parts of the rail network, so the Board has a legitimate role in protecting third parties from this harm. The Board has gradually strengthened its review of the risk of service disruptions from mergers, and the proposed rules are an additional step in this direction. In effect, the Board is adding "no harm through service disruption" to its traditional standard of "no harm through lost competition."

III. THE EFFECTS OF MERGERS ON THE RAILROAD INDUSTRY

The Board's mainstream approach to merger policy has served shippers, railroads, and the public well. While it is difficult to isolate precisely the share that mergers have contributed to the dramatic benefits of the past two decades of regulatory reform in the rail sector, there can be no doubt that mergers have played a significant role. Clearly, the nation's rail network would not be a better network if we had foregone the elimination of outmoded facilities, the end-to-end joining of previously balkanized systems into more seamless networks, and the additions of service and capital that mergers have permitted. Critics of rail mergers sometimes lament the declining number of Class 1 railroads, but it is not credible to maintain that railroads, shippers, or the U.S. economy would be better off if today's Class 1 railroads were split up into thirty separate systems, and the systems restored to their pre-merger configurations.

III.A Revitalization of the Rail Industry in the Staggers Era

The revitalization of the rail industry is one of the success stories of U.S. public policy over the last 25 years. Beginning with major regulatory reforms in the 1970s and culminating with the passage of the Staggers Act of 1980, the U.S. railroad industry has improved its performance substantially. Greater rate flexibility, deregulation of rates in certain markets, and opportunities for negotiated, tailored service offerings are among the factors that have brought railroads under the discipline of the marketplace. Regulatory reform has also allowed market forces to shape the ownership structure of railroad assets. Increased freedom to abandon low-density, unprofitable service and to consolidate rail systems in order to exploit network economies has contributed to improvements in the industry. The result has been a dramatic improvement in the nation's rail system. While there have been bumps in the road at times, these benefits have been shared both by the nation's railroads, who have improved their financial health, and by the nation's shippers, who have access to a railroad system that is more cost-effective, can provide quality service, and has shown rates that have trended clearly downward.

In response to opportunities provided by reformed regulation, the railroad industry has:

- Reduced average rates in nominal and real (inflation-adjusted) terms;

- Improved productivity of labor and capital;
- Increased capital expenditures on infrastructure; and
- Improved financial health for the railroads.

Some of these results are summarized in Figure 1. Nearly all measures available demonstrate that the improvements in the rail industry have benefited shippers, railroads, and the economy. As a result, this efficient rail system has become a key component in supporting the flow of goods and materials in an internationally competitive economy.

III.B The Role of Mergers in Industry Revitalization

Ownership restructurings have had an important role in the revitalization of the U.S. rail system. In the pre-Staggers era, the boundaries between rail systems were dictated more by history and politics than by the logic and incentives of the marketplace. The result was a rail network with boundaries between railroads that were largely economically arbitrary. The industry's declining physical condition was evidence that capital markets did not and would not invest in rail systems that could not realize efficiencies because of historically imposed structures and ownership patterns.

Many of the earliest mergers in the Staggers era involved railroads whose lines ran parallel to one another. The principal benefits from these parallel mergers were the elimination of lightly-used duplicative main lines and yards and improvements in traffic density. Later mergers have tended to be of railroads that meet end-to-end. The primary motive for end-to-end mergers has been to reduce the delays, unreliability, and transactions costs caused when traffic is handed from one railroad to another. The resulting increases in single-line service and longer hauls have not only increased speed and reliability of service for shippers, but also reduced railroad costs by improving the productivity of equipment and train crews. Research confirms that the post-Staggers mergers contributed substantially to increased efficiency in the rail sector—and to lower costs for shippers.[5]

While not disputing that past mergers have been beneficial, the Board asserts in its proposed rules that future mergers and other corporate restructurings are unlikely to produce

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[5] Research shows that the mergers of the 1980s significantly reduced railroad costs; see, for example, Vellturo, Christopher, et al., "Deregulation, Mergers, and Cost Savings in Class I U.S. Railroads, 1974-1986," Journal of Economics and Management Strategy (Summer 1992), 339-369.

public benefits through further rationalization of rail networks.[6] In making this assertion, the Board overemphasizes the role that capacity reduction has played as a source of merger benefits and discounts the other ways mergers generate benefits, such as reducing operating costs and improving service quality. As an example of merger-related cost savings, BNSF's operating ratio declined from 84.4 in 1994 to 75.4 in 1999—a decline of over 10% and a savings of approximately $800 million in 1999.[7] Over the same time period, operating ratios for other Class 1 railroads *increased* almost 5%, from 82.5 to 86.5.[8]

The Board's current overemphasis on capacity reduction overlooks the public benefits that mergers generate by enabling railroads to improve the service they offer their shippers. In particular, recent end-to-end mergers have been targeted at enhancing efficiency and output through the extension of single-line service offerings. Indeed, railroads that have participated in major mergers in the 1990s have increased their average length of haul by 21% (UP, SP, and CNW) and 23% (BN and ATSF) from 1994 to 1999, compared to a 6% increase in average length of haul for other, non-merging railroads.[9]

Single-line service enhances efficiency by eliminating costs and uncertainty associated with making and managing interline movements. In addition, expansion of single-line service typically represents a dramatic improvement in the quality of service a railroad offers its shippers. As railroads expand their offerings of single-line service, they can increase the speed of their service, make service more reliable, reduce damage and loss, and reduce capital requirements by making more efficient use of rail (and shipper) facilities. In the past, the Board has recognized that single-line service is a major source of public (and shipper) benefits:

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[6] "[O]ur proposed revision to the rules would recognize that this process [of rationalizing the nation's rail system and eliminating excess capacity] has now largely been completed, and that the efficiencies and service improvements to be realized from further downsizing of rail route systems are limited." Surface Transportation Board Decision, STB Ex Parte No. 582 (Sub-No. 1), Major Rail Consolidation Procedures, Notice of Proposed Rulemaking, October 3, 2000, at 11.

[7] *Quarterly Progress Report of the Burlington Northern and Santa Fe Railway Company*, Finance Docket No. 32760, January 18, 2000, at 80.

[8] *Analysis of Class I Railroads*, American Association of Railroads, 1994-1999.

[9] *Analysis of Class I Railroads*, 1993-1999.

> Single-line service is important to shipper logistics strategies. Interchange between railroads can be costly. As a result of the new single-line service capability of the combined BN/Santa Fe, shippers will likely see decreases in working capital requirements as base inventories shrink due to improved transit times, and as safety stocks of inventory are reduced because the combined system can eliminate the uncertainty of interchange. The transaction costs shippers incur in initial rate negotiations, in arranging equipment supply, tracking shipments, and in billing and payment procedures, will likely be reduced.[10]

The Board's view that extension of single-line service is an important source of benefit is confirmed by experience. Evidence reviewed below indicates that railroads have been notably successful in attracting substantial volumes of traffic to expanded single-line service options following merger. This demonstrates eloquently that shippers benefit from these services.

In sum, the available evidence does not suggest that the benefits from network integration have been exhausted. Figure 1 shows steady improvement in the performance of the industry through the mergers of the 1980s and the 1990s. Simple inspection of a map of the North American rail systems, moreover, shows that there are still opportunities to achieve integration of existing networks through end-to-end mergers. The most discussed opportunities, of course, are mergers that would form two transcontinental railroads in the United States.

III.C The Effects of Mergers on Competition

Critics of the post-Staggers merger policy argue that Staggers-era mergers have harmed shippers by significantly reducing the number of railroads. In particular, critics often cite the fact that the number of Class I railroads declined from approximately 30 in 1980 to fewer than 10 in 2000, largely as a result of mergers.[11] This statistic is extremely misleading and its use is demagogic.

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10 Decision No. 38 of the Interstate Commerce Commission, Burlington Northern and Santa Fe Pacific, August 16, 1995, Finance Docket No. 32549, at 65.

11 The other main reason the number of Class I railroads declined was because the Federal Railroad Administration increased the minimum size a railroad had to be to be classified as Class I. Six railroads operating today as independent regionals or shortlines were classified as Class I railroads in 1980.

In the first place, the total number of railroads in the nation as a whole is not a measure of the number of railroads individual shippers have to choose from. Since long before the Staggers Act, the vast majority of rail shipping points have been served by only one, or at most two or three, railroads. Moreover, the number of railroads serving a particular point is a misleading measure of competition. It is with good reason that merger policy admonishes that simple measures of market structure—including counting firms and measuring the concentration of their shares via such devices as HHIs[12]—are but a "starting point" for assessing marketplace competitiveness.[13]

In the case of railroads, competition from other modes, especially trucks and barges, is often very significant. The nature and potency of competition also depends on competition from other geographic locations and products. A steam coal mine might be served by only one railroad, for example, but that railroad will be constrained in raising its rates by the fact that the delivered price of the mine's coal must be competitive with the delivered price of coal from other mines and with the costs of alternative energy sources such as oil, natural gas, or hydro power. Indeed, the Staggers Act greatly increased the potential for geographic and product competition by making it possible for railroads and their customers to sign confidential long-term contracts. Under such contracts, the railroads have strong incentives to agree to reasonable rates because otherwise shippers will invest over time in other places and/or lines of business.

The fact that average rail rates have continued to decline even though the frequency of direct railroad to railroad contact has been relatively low is consistent with potent competitive forces from such sources as other modes, geographic locations and products. Despite the fact that most shippers served directly by a railroad continue to be served by only one railroad, average rail rates continued to decline in real terms during the 1990s.

Finally, as railroads have consolidated, the Board (and its predecessor, the ICC) has been vigilant in protecting the rail options of shippers. In the context of merger policy, the Board has established a strong precedent to preserve options for a shipper who had access

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12 The Hirschman-Herfindahl Index, computed as the sum of the squared values of firms' market shares.

13 See U.S. Department of Justice and the Federal Trade Commission, *Horizontal Merger Guidelines*, 1997, Section 2.0, "Overview."

to two rail options prior to a proposed merger. Indeed, merging parties no longer appear before the Board without first ensuring that their transaction preserves access to at least two rail options. There is no evidence that rail mergers have increased the number of solely-served shippers; the opposite is true. This bespeaks clear and forceful policy aimed at protecting competition and the public interest.

IV. APPROPRIATE PROTECTION AGAINST MERGER-RELATED SERVICE DISRUPTIONS

By their nature as networks, railroad systems are vulnerable to disruptions that can spread throughout the network. Vulnerability to these spillover effects was most dramatically demonstrated when disruption on the UP/SP system around Houston quickly backed up and disrupted the operations not only of other parts of UP but even completely separate systems. While a railroad has the clear economic incentive to prevent disruption of its own system, it can rationally ignore the effects of its disruption on *other* railroads' service, revenue, and profits. This implies an inefficiently weak effort to prevent disruption.

Of course, the foregoing does not mean that merging railroads will always under-protect against service disruption. Recent mergers, such as those between BN and the ATSF and the Canadian National/Illinois Central transaction, provide counterexamples that make it clear that the generalized disruption of the rail network is not an inevitable consequence of mergers. It is clear that the presence of service disruption is directly related to the method by which a merger is implemented.

In any case, as noted earlier, the Board has a legitimate role in protecting the public against merger-related service disruptions. In this respect, railroad mergers differ significantly from those in most other industries, where network externalities are not a significant factor. Further, the Board is correct in finding in this proceeding that its current policies are insufficient to protect against such disruptions, and to take the present opportunity to introduce policies that can provide necessary protection in the event of future mergers.

Such protection does not imply either a ban on mergers or the imposition of merger conditions that would discourage mergers by raising costs and risks to merging parties. Instead, we believe it is appropriate that the Board adopt mechanisms appropriately targeted at addressing its concerns about prospective merger-caused service quality degradation. Such mechanisms would reasonably include:

- A financial plan, endorsed by an independent expert, that demonstrates that the merger applicants have the wherewithal to undertake both those investments that are foreseen as necessary to achieve the planned merger of the parties' rail systems, as well as those investments whose need is unforeseen but that might be necessitated by service disruptions that arise unexpectedly.
- A thorough operating plan, including contingencies for possible service disruptions, that enables the Board and potentially affected parties to identify the ways service on other rail systems might be adversely affected by the merger.
- Post-merger quality-of-service guarantees that compel the merging parties to internalize the costs to their own and other railroads' systems and customers in the event of disruption that can be clearly attributed to a merger.

V. PROTECTING COMPETITION VERSUS "ENHANCING" COMPETITION

In a dramatic break from its current policy the Board now proposes to require merger applicants not just to protect competition that would otherwise be lost as a result of the merger, but to *enhance* competition:

> Applicants are expected to propose measures to mitigate and offset merger harms. These conditions should not simply preserve, but also enhance, competition. (p. 31)

This proposal assumes that future mergers will harm competition in ways that cannot be anticipated, so that competition must be enhanced by other means to compensate. But the presumption of competitive harm seems unwarranted, and the proposed remedy is of doubtful practicality and opens the door for political pressures and interference.

V.A The Presumption Of Competitive Harm From Future Mergers Is Unjustified

Previous experience and the recent evolution of the railroad industry do not suggest that future mergers will reduce competition in ways that cannot be identified or mitigated. As noted earlier, past mergers do not appear to have reduced the competitive pressures on the railroads. Competition has been preserved in part because railroads are subject to many sources of competition that are usually not affected by mergers. Railroads compete intensely with trucks and barges for many commodities and shipments, for example, and this intermodal competition is not reduced by rail mergers. Railroads also face competition from other geographic areas and products, and the extent of geographic and product competition was greatly enhanced when the Staggers Act made it legal for shippers to sign long-term contracts with railroads.

The Board has also played an important role in preserving competition by insisting that merger applicants offer trackage rights or other remedies that insure that any shipper served by two or more railroads before the merger still has a choice of at least two railroads after. Substantial evidence over the past several years and mergers indicates that Board-imposed and/or privately negotiated trackage, haulage and other conditions to preserve competition have been effective. For example, the I-5 agreement in the UP-SP merger and the Shared Asset Areas in the Conrail Transaction have increased the number of shippers that have had access to two or more railroads. The pro-competitive outcomes from rail mergers have typically occurred as a result of private negotiations to rationalize the operation of the rail network rather than a regulatorily imposed transaction cost on the merging process. The UP/SP oversight process has demonstrated the general effectiveness of these conditions. The rights granted to BNSF in this transaction gave competitive rail options to many shippers on the UP and SP systems. BNSF attracted over 340,000 loaded units of traffic in 1999 on the routes to which it was granted rights as part of the UP/SP merger.[14]

Most recent railroad mergers involve railroads whose route networks connect end-to-end rather than running parallel to one another. Economic analysis indicates that end-to-end mergers are unlikely to cause competitive harm. Unlike parallel mergers, end-to-end mergers do not involve significant network overlaps, so that few or no shippers face a potential reduction in the number of railroads that serve them. Moreover, end-to-end mergers are the equivalent to vertically integrating the various routes served by railroads, and the overall impact of integrating and rationalizing the ownership of the rail network is pro-competitive through reduced costs and improved overall service. Indeed, the ability to reduce costs by making the most of economies of scale and scope and offering improved single-line service has motivated recent mergers.

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[14] *Quarterly Progress Report of the Burlington Northern and Santa Fe Railway Company*, Finance Docket No. 32760, January 18, 2000.

The Board appears to recognize that future mergers are also likely to be end-to-end, and thus that threats to multiple rail access are likely to be less of an issue in the future than they have been in the past. The proposed BN-CN transaction that was withdrawn following the STB merger moratorium, for example, involved little network overlap and little loss of multiple rail access prior to the granting of conditions. And the most plausible remaining opportunities would involve end-to-end mergers to create transcontinental carriers.

Instead, the Board has identified potential reductions in geographic and product competition as a major concern and the primary reason why future merger applicants should be required to enhance competition. Geographic competition occurs when a product is available from many locations, so that transportation rates are constrained by the need to meet the delivered prices from elsewhere.[15] Similar forces work in the origin markets. Geographic competition is typically most effective in the case of relatively fungible commodities, such as grains, coal, or other raw materials that are available from a variety of sources and have numerous customer outlets.

It is puzzling why the Board appears to believe that potential reductions in geographic competition cannot be identified and mitigated in the same ways that potential reductions in multiple railroad access have been dealt with in the past. Potential losses in geographic competition have been raised in previous rail mergers, and the steps for assessing those losses are relatively straightforward. For the loss of geographic competition to be a significant issue in a merger proceeding, one needs to show that geographic competition was, prior to the merger, the constraining factor on the potential for the exercise of market power, and that the merger would eliminate such competition. Such a demonstration would involve identifying an economically relevant product and set of shipments for which intramodal, intermodal and product competition were ineffective competition, for which the merging railroads were competing in delivering those shipments to the same general locations, and for which the combination of the two rail carriers altered the process of geographic competition with the other carriers delivering the product so that there was a significant risk for the creation and use of market power.

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15 Product competition works in a similar manner via other similar products that satisfy customers' needs that serve to restrain delivered pricing.

Similarly, the steps to mitigate any threatened reduction in geographic competition seem equally straightforward. The merger applicants would be expected to offer trackage rights or similar remedies to preserve geographic competition, much as they have been expected to offer trackage rights to preserve shipper access to multiple railroads. And if the applicants did not volunteer a satisfactory remedy, the Board would be free to impose a remedy as a condition for the approval of the merger.

The Board's concerns are also hard to understand because future mergers are unlikely to pose serious threats to geographic competition. When the issue has been raised in previous rail mergers, the evidence has not supported a finding of competitive harm through the loss of geographic competition. Moreover, the factors that contribute to the loss of geographic competition are less likely to be in evidence in future mergers than they were in the past. Several of the major mergers in the 1990s, while predominantly end-to-end, at least involved railroads operating in the same broad geographic areas, such as the BN/SF, the UP/SP, and the Conrail transaction. In a proposed merger of one of the western and eastern railroads, for example, the railroads would not for the most part serve the same regions for most of the traffic. Thus, unlike the case of the western railroads that transported similar products (e.g. grain) that originated over the region for delivery to similar locations (e.g. the Gulf Coast ports), a merger between one of the western and one of the eastern railroads is likely to have greater differences in product and geographic overlap than in previous mergers.

Previous mergers have involved extensive evidentiary findings regarding the process of competition—inter-modal, intra-modal, and geographic—and the likely effect of the merger. Evidence and previous Board rulings indicate that most proposed mergers have not presented significant risks of competitive harm, once competition-preserving conditions have been granted. The Board has successfully obtained and evaluated evidence on the prospective competitive harm that a merger could pose. The Board's ability to obtain similar evidence and perform similar analyses are unaffected by previous rail consolidation. There is no reason that the Board will be unable to make similar evaluations in the future.

V.B "Enhanced" Competition and Rent-Seeking

The requirement to "enhance" competition—through whatever means the Board decides would meet its new standard—would undoubtedly encourage rent-seeking by intervenors. The Board proposes no clear standard for how and how much competition must be enhanced. This vagueness stands in sharp contrast to the clear and traditional merger standard of identifying and protecting against specific likely harms to competition. This vagueness creates uncertainty and will encourage intervention and rent-seeking by all comers who could benefit from a regulatorily imposed condition as part of a merger. Any and all shippers, regardless of the merit of their position, will have the incentive to seek conditions that grant them more than they currently have.

Rent-seeking occurs when there are benefits being bestowed whose value exceeds their price. In the situation established by the proposed rule, the Board would bestow access to enhanced competitive conditions on shippers that are otherwise not harmed by the merger. These conditions could, for example through the introduction of trackage rights, provide a shipper that possessed ample competitive options with access to new single-line service on a non-merging railroad. To the extent that the conditions being offered or imposed have value to shippers, shippers will have the incentive to negotiate directly with the railroad, intervene in the proceeding, and/or appeal to the Board to impose conditions. Every shipper will have the incentive to seek as much of the available "rent" for itself as possible.

Administrative rent-seeking wastes society's resources. The need to "buy off" intervenors will likely result in expensive and inefficient outcomes that dissipate benefits from further vertical integration in the rail industry. These "payments," expressed in terms of "enhanced competition conditions" or other concessions to shippers, are likely to be expensive to the railroad. In the absence of a clear standard, it will be difficult to limit or constrain the requests for favors and difficult to prevent arbitrary outcomes based on the success of shippers' bargaining. While the railroads have the incentive to meet the enhanced competition rule in as efficient a method as possible, the dispensation of favors is likely to reflect the perceived effectiveness of different shippers in proceedings before the Board. Indeed, in this type of negotiated process with no clear standard, the railroad may need to make private concessions to shippers that have nothing to do with enhancing competition. Instead they will represent a bribe to prevent further intervention and delay in the rail proceeding.

While the free-for-all between shippers and merging railroads to dispense favors is wasteful, inserting the Board deeply into the process is likely to make it worse. Unlike the railroad negotiating with its customers, the Board generally will lack the information (e.g., knowledge of traffic patterns) to establish sets of conditions that have value to the shipper and can be provided efficiently. The problem of rent-seeking will be exacerbated by shippers seeking relief before the Board and the Board needing to decide which shippers will get what kind of benefit from "enhanced competition" and in what form this condition will occur. To the extent the Board imposes enhanced competition as a merger standard, these imposed conditions are likely to be more unwieldy, arbitrary, and inefficient than arrangements reached through private two-party negotiation.

V.C Problems of Implementation

While the Board calls for enhanced competition, it does not specify what that means beyond providing a list of alternatives. At the very least, the Board seems to want to expand the trackage, haulage, third-party access, and other forms of organization that have occasionally been introduced in previous mergers. In the future, however, these measures would not be limited to situations where they were needed to mitigate potential competitive harm due to the loss of a rail competitor. Instead, they would be applied more widely.

The widespread introduction of trackage rights and similar measures would transform the rail industry by essentially dividing train operations and infrastructure maintenance into separate companies. The typical railroad might still both operate trains and maintain track, signals, way, yards and other infrastructure. Increasingly, however, the trains it operated would run on other railroads' tracks while the tracks it maintained would be used by other railroads' trains.

While trackage rights and similar measures have been effective when used selectively to mitigate specific competitive harms, their generalized application would pose serious difficulties. All forms of access—whether trackage, haulage, joint access areas, or mandated access—require the resolution of complex coordination problems between the railroad granting the access and the railroad using it. Although successful, the BNSF/UPSP agreement, for example, has been the subject of ongoing dispute and review by the Board regarding operations and infrastructure investment.[16] The service problems in the East following the Conrail transaction have, at least in part, resulted from the difficulty of solving

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[16] For examples, see STB Finance Docket 32760 Decision No. 61 (November 19, 1996); Decision No. 81 (September 30, 1998); Decision No. 86 (July 9, 1999); and Decision No. 89 (May 31, 2000).

the coordination problem in the shared areas.[17] Indeed, the history of disputes over shared assets goes back to the earliest days of the rail industry.[18] These agreements permit the sharing of expensive network resources, but also involve disputes, inefficiencies and, sometimes, third-party intervention by the Board to resolve disputes over coordination issues such as the need to share tight capacity.

The coordination problems introduced by separating train operations from infrastructure are similar to those that occur when two railroads interline traffic. Indeed, as we have noted, a primary driver of recent mergers in the railroad industry has been the need to solve the coordination problems of interlining so as to improve service to customers.[19] The problem of interchanges is one of coordination: how are priorities met?; what investment needs to be made?; which train gets priority to scarce yard capacity? When infrastructure capacity is slack, the problem of prioritizing activities is less difficult. When capacity is tighter and more valuable, the problem of coordinating access to that capacity in a shared environment becomes more difficult. The integrated firm can make these decisions internally with a common incentive to maximize profits through meeting customers' demands. When assets are shared and incentives are misaligned, negotiations must take place and agreement is not assured.

There are strong reasons for believing that the coordination problems created by mandated access or other arm's-length approaches to "enhancing" competition are more serious in railroads than in other network industries such as electricity, natural gas, and telecommunications. Unlike electricity and natural gas, for example, rail freight service is not fungible—freight must travel between a particular origin and destination, and the terms of service, cost, speed and provision of reliability vary among shippers and products.[20]

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17 STB Finance Docket 33388, First General Oversight Report of Norfolk Southern Corporation and Norfolk Southern Railway Company, June 1, 2000, pp. 12-13.

18 See, e.g., Atchison, Topeka & Santa Fe Ry. Co.—Operating Agreement, 331 I.C.C. 367 (1967); Atchison, Topeka & Santa Fe Ry. Co.—Operating Agreement, 8 I.C.C.2d 297 (1992).

19 See the discussion in section VI regarding the success of the arm's-length negotiated Avard agreement compared to a vertically-integrated merged railroad as an example.

20 José A. Gómez-Ibáñez, "Regulating Coordination: The Promise and Problems of Vertically Unbundling Private Infrastructure," Discussion Paper, John F. Kennedy School of Government, Harvard University, December 1999.

Excess (and often relatively low cost) capacity reduce the problems of coordination in telecomm systems. On the other hand, the interdependence of different geographic portions of congested rail networks and between operations and necessary investments in track, signaling, and other infrastructure facilities are significant. Similarly, the fixed and sunk costs of the common infrastructure are high relative to the value of the service provided and require returns over very long lifetimes. Each of these factors raises the bar to cooperative, negotiated outcomes. The incentive to share expensive, congestible infrastructure capital and improve service is high; the fact that railroads have had difficulty doing this effectively demonstrates the difficulty of achieving these gains through arm's-length negotiations.

The experiences of the few countries that have attempted to enhance competition by effectively de-merging portions of the rail sector (e.g., through mandated access) confirm the difficulties of across-firm coordination. The case of mandated access on the rail network in Great Britain, for example, has been well-studied and is illustrative.[21] The problems of negotiating shared access to the infrastructure as it reaches capacity limits and, especially, investments to expand capacity and improve infrastructure have been large. Negotiations frequently are three-way—two private parties and the rail Regulator. While simple and obviously valuable projects do get approved and implemented, high transaction and negotiation costs and delay discourage many worthwhile projects that would otherwise be undertaken by a vertically integrated railroad.

Experience in the U.S. and abroad confirms the significant risks that a policy of extensive and imposed "enhanced" competition brings. Focussed and small scale arrangements that enhance competition where the interests of the parties sharing access are similar can be effective. The broader and more intrusive these conditions become, and the more they are imposed by third-parties, the greater the coordination costs become. Indeed, these types of arrangements can ultimately become a bar to efficient investment and service, when incentives diverge.

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[21] See the discussion in Section IV of Gómez-Ibáñez, "Regulating Coordination: The Promise and Problems of Vertically Unbundling Private Infrastructure," Discussion Paper, John F. Kennedy School of Government, Harvard University, December 1999.

V.D Competition "Enhancement" and the Regulatory Paradigm

The requirement of enhanced competition, in whatever form, also threatens to undo, in the context of merger policy, the underlying structure of post-Staggers rate regulation. Thus, the Board's proposed rule represents a "paradigm shift" not only in merger policy, but in the fundamental principles of rail regulation as it is practiced in the Staggers era. Such a comprehensive change should not be introduced without careful consideration of all of its effects.

Existing regulatory policy recognizes that the rail industry is a network industry with high fixed costs that serves different shippers with different competitive alternatives. Differential pricing, in which railroads can charge some shippers more than other shippers that may have better competitive options, subject to regulatory protections on the higher rates, provides the mechanism by which railroads have the possibility of obtaining a return on capital adequate to support past and future investments. This policy, for the most part, has worked well for both railroads and shippers. In the absence of differential pricing, there is no source for revenue to maintain the shared costs of the rail network.

The imposition of enhanced competition as a condition of merger will hamper the railroads' ability to engage in differential pricing and reduce their revenue in a manner unrelated to cost reductions the merger might bring. In effect the requirement to enhance competition is a tax on the merging parties. This tax would not only discourage mergers that would be in the public interest, but also exacerbate the problem of providing a sufficient return to railroad investment. Without an adequate return the railroads will be unable to attract capital for maintenance of the existing networks and for future infrastructure expansion.

The imposition of its proposed competition enhancement standard may have other impacts that the Board either has not foreseen or has not sufficiently considered. Such dramatic policy changes require a level of analysis and debate far more comprehensive than the current proceeding—focused on *merger* policy—has provided.

VI. NON-MERGER ALTERNATIVES

The Board proposes to introduce a new standard for the quantification of the net benefits of a proposed merger. In quantifying net public benefits of the proposed transaction, the Board would apparently include only those benefits that can be shown affirmatively to be unachievable by non-merger alternatives:

> [T]he Board will also consider whether the benefits claimed by applicants could be realized by means other than the proposed consolidation. The Board believes that other private sector initiatives, such as joint marketing agreements and interline partnerships, can produce many of the efficiencies of a merger while risking less potential harm to the public. (p. 44)

Implementation of this new net benefits standard would substitute the regulator's judgment, mediated through contentious litigation, for the demonstrated judgment of the market players who put their capital at risk when deciding on the efficiency of merger and non-merger coordination transactions.

It would be irrational for two railroads to propose an end-to-end merger unless they believed that the merger would generate cost savings and service improvements that they could not gain by other means. The cost, delay, and uncertainty of the merger process give railroads strong incentives to seek their ends by other means. The fact that railroads continue to pursue end-to-end mergers is thus strong evidence that mergers can provide benefits that are unavailable via other types of transactions. Railroads' preference in many cases to achieve integration through merger rather than alternative contractual arrangements is driven by the underlying economics of the rail industry. In order to move traffic from origin to destination while meeting the service needs of shippers, railroads must solve a technical coordination problem. Railroads allocate resources and coordinate decision-making regarding scheduling, routing, allocating locomotives, prioritizing car switching, moving trains through congested yards, etc. These decisions interact in ways that can affect numerous portions of a railroad's operations and the shippers who use that system. As a result, railroads establish complex operations, procedures, and protocols that attempt to balance the needs of all of their shippers, and rail managers are constantly deciding in real time which trains should have priority and what actions to take when unplanned contingencies occur.

We can imagine a hypothetical rail network in which each successive mile of track is owned by a different railroad. In such a situation, the types of decisions described above would need to be coordinated through negotiations or complex contracts involving multiple parties that set out as many foreseeable contingencies as possible, perhaps simplifying or ignoring certain economic interactions. Since there are significant costs associated with writing complex contracts or engaging in ongoing negotiations. we do not see the foregoing ownership structure in railroading. Rather, we observe integrated railroads with significant geographic scope to their ownership and operations. The extent of a railroad's system provides the reach over which key capital and operating decisions can be resolved more efficiently and at a lower cost by managerial discretion rather than through the use of contracts or other coordination mechanisms between separately owned firms. Operations within a single firm allow management to coordinate operations and to align operational and marketing priorities. When it is recognized that the use of arm's-length mechanisms is hardly costless and efficient in the face of the challenges of running a network, making judgment calls about these priorities is properly placed inside firms, not out on the market between firms.[22]

Contractual relationships often require parties to bear large transaction costs, particularly when agreements must be closely monitored to ensure compliance. Real world negotiations include a high level of uncertainty and differences in expectation about both the current state of the world (e.g., the ability of coordinated service to attract new business immediately) and the future (e.g., how the agreement will evolve). This makes it difficult to reach, monitor, and enforce mutually beneficial marketplace agreements.[23] When parties have different information, different expectations, and different alternative opportunities, they will also tend to value the benefits of a relationship differently. For example, railroads may have differing infrastructure capacities, equipment needs, costs of providing service, and/or marketing priorities. It can be difficult and costly for parties to reach and implement an agreement when they cannot even agree on the benefits that they will share.

Even when firms can agree on the benefits, they tend to have their own financial interests and priorities. Under such circumstances, writing sufficiently complex contracts to incorporate the myriad details and contingencies needed for successful integration is quite difficult. Since many of the benefits are shared over the network as a whole, independent firms must properly concern themselves with how those benefits will be divided between them. As a result, firms behave reasonably and tend to protect their individual interests,

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22 This is the Coasian explanation for the existence of firms. See Coase, R.H., "The Nature of the Firm," *Economica*, November 1937, at 386-405.

23 Williamson, O. E., *Markets and Hierarchies: Analysis and Antitrust Implications, A Study in the Economics of Internal Organization*, 1975, at 234-247.

insisting on their individual priorities and strategies. This can make full coordination infeasible. Customers' needs go unserved and "money is left on the table"—i.e., business that could be gained through more efficiently organized and coordinated operations. Capturing such business provides the lure to mergers that improve network coordination by bringing the problems and incentives under the control of single ownership.

The pı   ın of inducing mutually beneficial arm's-length arrangements is doubly hard when durable capital needs to be sunk and shared to realize the benefits of economic success.[24] Issues related to how to apportion capital expenditures across parties are especially difficult when the benefits that accrue from such an investment will be distributed across the network. Indeed, basic economic reasoning indicates that there may exist no equilibrium set of arm's-length contractual relationships by which to decide efficiently who should pay what share of costs and who should receive what share of revenues under conditions in which network assets are jointly used by independent parties.[25] Moreover, it is often infeasible for contract duration to be as long as the useful life of investments in an industry with such long-lived, sunk capital as railroading. These factors act to limit independent firms' willingness to commit necessary capital to investments that an integrated firm would readily undertake. Under such circumstances, customers' needs can go under-served and, to capitalize on the business opportunities this creates, efficient marketplace forces push companies to bring operations that need to be coordinated over the use of long-lived, sunk capital under the roof of one firm.

Therefore, combinations are driven by the desire and need of the industry to invest in infrastructure and capacity. Therein lie the pressures that have been driving railroads to rationalize previously balkanized ownership boundaries by building and consolidating integrated rail networks in the post-Staggers era. Second guessing these pressures by opening up proposed mergers to intervention by third parties able to garner private benefits from merger approval proceedings is poor policy.

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[24] Klein, B., R.G. Crawford, and A.A. Alchian, "Vertical Integration, Appropriable Rents, and the Competitive Contracting Process," *The Journal of Law and Economics*, October 1978, at 297-326.

[25] See, for example, Gómez-Ibáñez, José, "Regulating Coordination: The Promise and Problems of Vertically Unbundling Infrastructure," Taubman Center for State and Local Government, John F. Kennedy School of Government, December 1999.

These implications from economics are supported by recent railroad industry experience. The consolidation of the Burlington Northern (BN) and the Atchison, Topeka & Santa Fe (Santa Fe) provides a clear "natural experiment" by which to compare inter-railroad contractual coordination as a substitute for merger. In the early 1990s, several years before their merger, BN and Santa Fe instituted a cooperative marketing agreement to move intermodal traffic over Avard, Oklahoma, via a haulage agreement. The railroads were particularly interested in high priority intermodal service between the West Coast, served by Santa Fe, and the Southeast, served by BN to Memphis and beyond. Because of differing management priorities, however, the agreement did not work as effectively as might have been hoped. The issue that impeded the cooperative effort was primarily that operating departments could not coordinate sufficiently to get one intermodal train in each direction to run consistently on time. Without a high degree of reliability, the service was not attractive to the high priority customers that it was targeting.

In 1995, BN and Santa Fe consummated their merger, and operating decisions have since been coordinated within a single firm, rather than through contractual relationship. Tellingly, since the merger, intermodal traffic has increased sharply. As shown in Figure 2, and notwithstanding strong pre-merger incentives and concerted effort to find non-merger mechanisms for capturing new business available through coordination, these increases have been seen at multiple points in the BNSF nexus. Traffic through Memphis, for example, has increased by 68%. As a point of comparison, intermodal traffic for the US as a whole increased 14% from 1995 to 1999. The results realized post-merger by BNSF dwarf this figure. This is true not only for the Memphis traffic, but holds in such areas as Texas to California (up 56%), Chicago to California (up 49%), Chicago to the Pacific Northwest (up 40%), and between Minnesota and California, Arizona, and New Mexico (up 170%). This burst in performance is clearly merger-related: Prior to their merger, BNSF had no incentive to ignore this business if there had been viable non-merger alternatives for chasing it.

BNSF's post-merger success in increasing its movements of Midwestern agricultural products provides further evidence that coordinating operations within a single firm can enable railroads to improve service and attract customers. Prior to the merger, Santa Fe had very few corn origins and transported relatively small amounts of corn to the livestock destinations it served. By combining BN's corn origins with Santa Fe's livestock destinations, the merger has enabled BNSF to increase its share of corn delivery to these destinations. For example, pre-merger Santa Fe transported less than 20% of the corn delivered to feedlots in the Texas Panhandle. After the merger, BNSF was able to attract the construction of two high capacity unloading facilities in the Hereford, Texas area, and BNSF now transports 50% of the corn delivered to Texas Panhandle feedlots. BNSF has had similar success in shipping corn from the Midwest to dairy, poultry, and feedlot facilities in California. The former Santa Fe transported only 10% of the corn delivered to these markets. After the merger, BNSF was able to attract the construction of four high capacity unloading facilities in the central California area and BNSF now transports 40% of the corn delivered to these markets.

VII. CUMULATIVE IMPACTS AND CROSSOVER EFFECTS

The Board proposes to require that merger applicants predict whether their merger will provoke other mergers in the future and then analyze the "cumulative impacts and crossover effects" of their proposed merger and the subsequent mergers they think most likely. This requirement stems from a fear that otherwise the Board will be reviewing individual mergers in isolation, without any understanding of their subsequent or wider implications. While the Board's concern is perhaps understandable, the proposed remedy is flawed and the concern seems exaggerated or misplaced.

The Board's proposal is flawed in so far as it is extremely difficult to predict the future configuration of the railroad industry with much accuracy. As noted earlier, the industry's incentives continue to push it toward efficient rationalization of ownership boundaries through end-to-end consolidation. However, statements about which companies will merge with others and when, if ever, in response to those incentives are necessarily highly speculative. The few economic analyses that have sought to predict mergers among firms are plagued by thorny methodological issues and generate results that relate acquisition likelihood to general firm characteristics (such as to firm size and R&D intensity), rather than providing the predictions of specific merger pairs that the Board appears to be seeking.[26] Moreover, the record of past accurate predictions is relatively poor. Figure 3 delineates the tumultuous events that resulted in the Conrail transaction. Figure 4 shows that the path to merger for Burlington Northern and Santa Fe was similarly tortuous. A review of the contemporaneous trade press shows that the course of events surrounding these highly

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[26] See, for example, "Estimation of the Probability of Acquisition in an Equilibrium Setting" by Hall, Bronwyn H., University of California at Berkeley Working Paper in Economics: 8887, August 1988.

contested mergers was generally unforeseen. Thus, there is a real danger that applicants and the Board will waste time analyzing combinations that may never come to pass and still end up being surprised by actual events.

Equally important, the fear that a merger can not be assessed unless all of its future implications are known seems exaggerated. The concern seems to be that the Board's approval of one merger might compel other railroads to merge defensively, and that the cumulative effects of all these mergers might not be in the public interest. But why would other railroads be forced into defensive mergers? It could not be because the merged railroad had gained more market power over "captive shippers" since the current Board policy requires that the options of shippers not be reduced by the merger; and a merger that somehow enhanced market power would improve the lot of other railroads who are thereby made more attractive to customers. If one consolidation triggers a "defensive" merger by other parties it will be because the merged railroad has gained some service or cost advantage over other railroads by virtue of its merger—i.e., the merged entity is more efficient and better able to meet customers' needs. And if that is the motive that is compelling the defensive mergers, then the defensive mergers must logically be in the public interest too.

In this context, there is no sound economic reason to believe that the case-by-case approach that the Board (and the regulators of other industries) has traditionally followed is inappropriate. As long as the Board continues to approve only mergers that protect competition and prevent service disruptions, mergers which occur will enhance efficiency and performance. The pressure this may put on other railroads is precisely the result policy should seek. There is no reason to think that the Board will be "forced" by the results of a current merger to approve future mergers that are not in the public interest.

Indeed, the proposed requirement to consider cumulative and crossover effects could well be expected to have the undesirable effect of increasing the political pressures on the Board to step in and manage the structure and timing of railroad consolidations. The temptations for the Board to try to manage the industry structure are strong—its predecessor, the ICC, attempted to do so many times, most notably with its consolidation plans in the 1920s and 1970s. But pre-planning of the industry structure oversteps the regulator's proper role of protecting competition. Moreover, such planning is bound to increase the number of intervenors in merger cases and intensify the political pressures on the Board simply because this type of planning necessarily creates winners and losers. The Board is unlikely to be able to second-guess the industry as to which combinations are likely to offer the greatest gains in efficiency and service quality. Worse, faced with so many pressures, the process will be pushed to abandon difficult and careful analysis and instead fashion a plan that simply attempts to compromise or balance all the claims and issues raised by the many parties. The historical experience of the rail industry under the previous regulatory regime shows the deleterious effects of the political system's involvement in the micro-management of business decisions and industry structure.

In short, even if it were possible to predict future mergers with accuracy, it would be inappropriate to use such predictions to block a proposed merger. Each application should be judged on its own merits, according to the principles of sound merger policy. The "looming possibility" of subsequent merger applications is no reason to prevent a proposed combination that meets traditional merger policy criteria. And proposed mergers should not be impeded by a proposal that imposes substantial new burdens on applicants, elevates speculation to the role of evidence, and opens a Pandora's box of political pressures and temptations while adding nothing of value to the merger review process. The goals of sound merger policy would be better served by a more limited measure that would require a merger applicant to consider the effect of any concurrent merger application. While burdensome, such a requirement would be consistent with a desire to analyze predictable (as opposed to unpredictable) competitive effects.

VIII. BENEFIT GUARANTEES

The Board proposes that future merger applications should include mechanisms to guarantee the achievement of forecast public benefits:

> [A]pplicants must suggest additional measures that the Board might take if the anticipated public benefits identified by applicants fail to materialize in a timely manner. (p. 32)

This rule appears to be designed to offset any incentives that merger applicants might have to overstate merger benefits. The rule would hold the applicants' feet to the fire by punishing railroads that failed to achieve the benefits they projected in their application. The Board does not discuss specific mechanisms that might be used for this purpose.

The Board's presumption that applicants have incentives to overstate merger benefits is plausible. The Board currently does not apply sanctions if projected benefits do not materialize, so there is little reason for applicants not to present benefits optimistically. Nevertheless, the Board's remedy appears both unnecessary and impractical. It is unnecessary from a public policy perspective as long as the Board continues its current policy of approving mergers only when it is convinced that the merger will cause no competitive or other harms. If a merger causes no harm, then it will still be in the public interest no matter how small the benefits ultimately prove to be. This is why mainstream merger policy as practiced in other industries—and as reflected in the Board's current policy—presumes that regulators need not overly concern themselves with merger benefits.

Moreover, mergers are properly seen as promising significant benefits because it would be irrational for applicants to propose one that did not. As explained above, mergers impose substantial risks and costs on the applicants and would not rationally be proposed unless they promised efficiency and service gains that could not be achieved by other means. Thus, even if we assume that applicants present benefits optimistically, they also have powerful incentives to invest in only those prospective mergers that they expect will produce substantial benefits.

Additionally, railroads have clear and powerful incentives to try to realize the benefits they expect once the merger is approved. The estimated public benefits—such as cost savings and better service (leading to increased volumes and revenues)—are also the main source of private benefits to the shareholders. If the public benefits fail to materialize, shareholders suffer directly and immediately through lower profits and falling stock prices. As a result, railroads have strong internal incentives to implement a merger skillfully so that the benefits they had hoped for actually materialize.

Finally, there are serious practical problems with implementing a rule to guarantee the achievement of estimated benefits. Such a rule presumably would be designed to punish merging parties only for those after-the-fact benefit shortfalls that resulted from the applicants' before-the-fact exaggerations. The estimated public benefits of a merger are inevitably based on forecasts of many uncertain variables, however, such as the rates of growth of the economy, of specific regions and industries, and of freight shipments along particular corridors. Actual benefits may diverge from projected because of events that are unexpected and completely outside the control of the merger applicants. Everything from changes in the overall economy or the weather could result in forecasts being inaccurate—in either direction—after the fact. Drawing an analytically and procedurally robust line between shortfalls that result from supposed exaggeration and other shortfalls (or overruns, for that matter) would be problematic, procedurally expensive, and politicized, to say the least. This is not consistent with sound regulatory approaches to ensuring serving the public's interest.

Attachment 1

José A. Gómez-Ibáñez

José A. Gómez-Ibáñez is the Derek C. Bok Professor of Public Policy and Urban Planning at Harvard University, where he holds a joint appointment at the John F. Kennedy School of Government and the Graduate School of Design. He teaches courses in economics, policy analysis, infrastructure and transportation policy in both schools.

Professor Gómez-Ibáñez has published numerous articles on transportation policy and regulation and is co-author of several books including *Essays in Transportation Economics and Policy: A Handbook in Honor of John R. Meyer* (with William Tye and Clifford Winston; Brookings, 1999); *Going Private: The International Experience with Transport Privatization* (with John R. Meyer; Brookings, 1993); *Regulation for Revenue: The Political Economy of Land Use Exactions* (with Alan Altshuler; Brookings, 1993); *Autos, Transit and Cities* (with John R. Meyer; Harvard, 1981); and *Cases in Microeconomics* (with Joseph Kalt; Prentice-Hall, 1990).

At the University, Gómez-Ibáñez currently serves as the faculty chair of the Masters in Urban Planning Program at the Design School and the faculty co-chair (with Henry Lee) of the Infrastructure in a Market Economy executive program at the Kennedy School. In the past he has served as the chairman of the Masters in Public Policy program at the Kennedy School, and as Chair of the Department of Urban Planning and Design and of doctoral programs at the Graduate School of Design.

In addition, Professor Gómez-Ibáñez has served as a consultant and advisor on transportation policy and regulation issues to government agencies both here and abroad. He served as senior staff economist to the President's Council of Economic Advisors (1980-81), where he was responsible for regulation, transportation and environmental issues. He has chaired the Mayor's Transportation Advisory Committee in Boston (1985-86) and has been consultant to the governments of Singapore, Indonesia, Guatemala, Bolivia, Chile, Argentina, Spain and other countries. He is a member of the American Economic Association, the American Planning Association, and the Transportation Research Forum.

Ph.D., Public Policy	Harvard University (1975)
M.A., Public Policy	Harvard University (1972)
A.B., Government	Harvard University (1970)

Joseph P. Kalt

Joseph P. Kalt is the Ford Foundation Professor of International Political Economy and chair of the Economics and Quantitative Methods Cluster at the John F. Kennedy School of Government at Harvard University. Professor Kalt is a specialist in the economics of antitrust and regulation, with particular emphasis on the natural resource and transportation sectors. His publications in the area include: *The Economics and Politics of Oil Price Regulation*; *Drawing the Line on Natural Gas Regulation* (with Frank C. Schuler); *Petroleum Price Regulation: Should We Decontrol?* (with Kenneth Arrow); and *New Horizons in Natural Gas Deregulation* (with Jerome Ellig). Professor Kalt has testified frequently before the U.S. Congress, federal and state regulatory commissions, and in state and federal legal proceedings on matters of competition policy, mergers, and industry regulation.

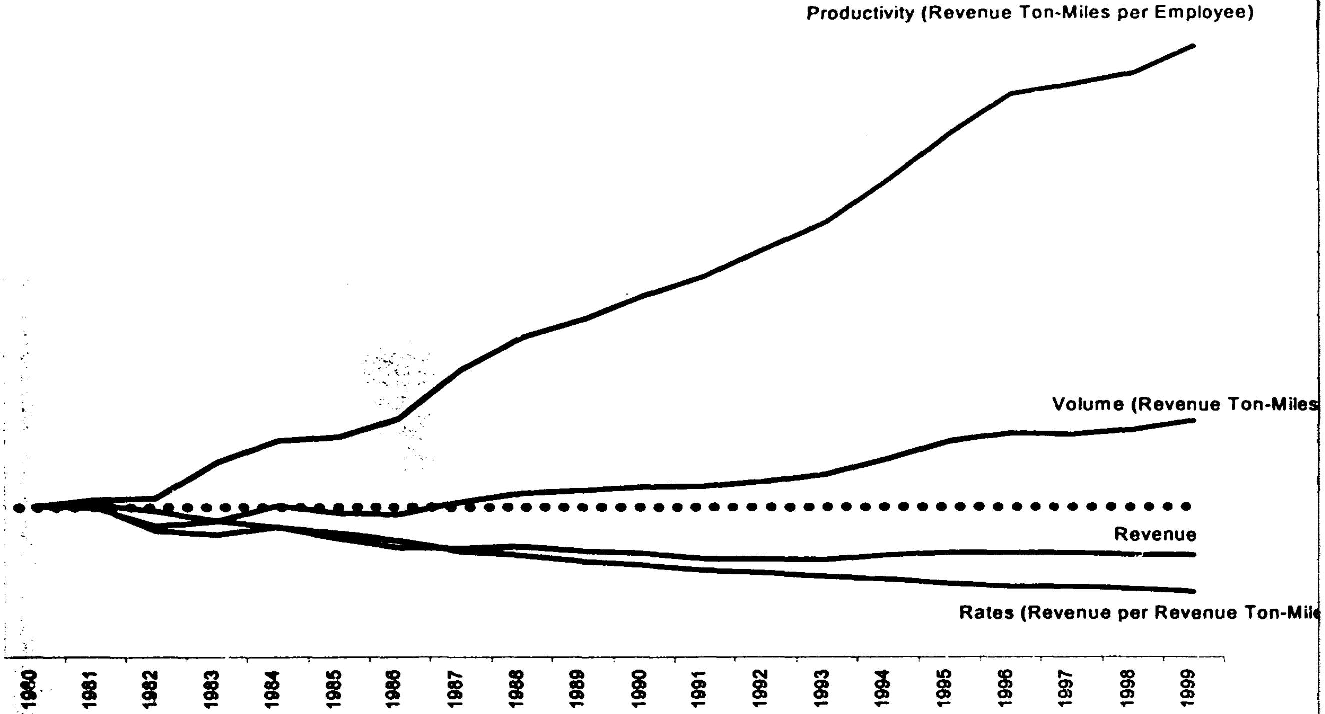
Professor Kalt is also co-director with Stephen Cornell and Manley Begay of The Harvard Project on American Indian Economic Development and the National Executive Education Program for Native American Leadership. In addition, he is the co-editor with Stephen Cornell of *What Can Tribes Do? Strategies and Institutions in American Indian Economic Development*. Since 1987, the Harvard Project has worked for and with tribes and tribal organizations, providing research, advisory services, and education on issues of nation-building in Indian Country.

Professor Kalt has served as the Kennedy School's Academic Dean for Research, chair of degree programs, and chair of Ph.D. programs. He is also a member of the Board of Trustees of the Fort Apache Heritage Foundation of the White Mountain Apache Tribe (Arizona), the Board of Trustees of the Foundation for American Communications, and the Faculty Advisory Board of the Harvard University Native American Program. He served as advisor to the Royal Commission on Aboriginal Peoples, a commissioner on the President's Commission on Aviation Safety, and on the Steering Committee of the National Park Service's *National Parks for the 21st Century*.

Ph.D., Economics	University of California at Los Angeles (1980)
M.A., Economics	University of California at Los Angeles (1977)
B.A., Economics	Stanford University (1973)

Figure 1

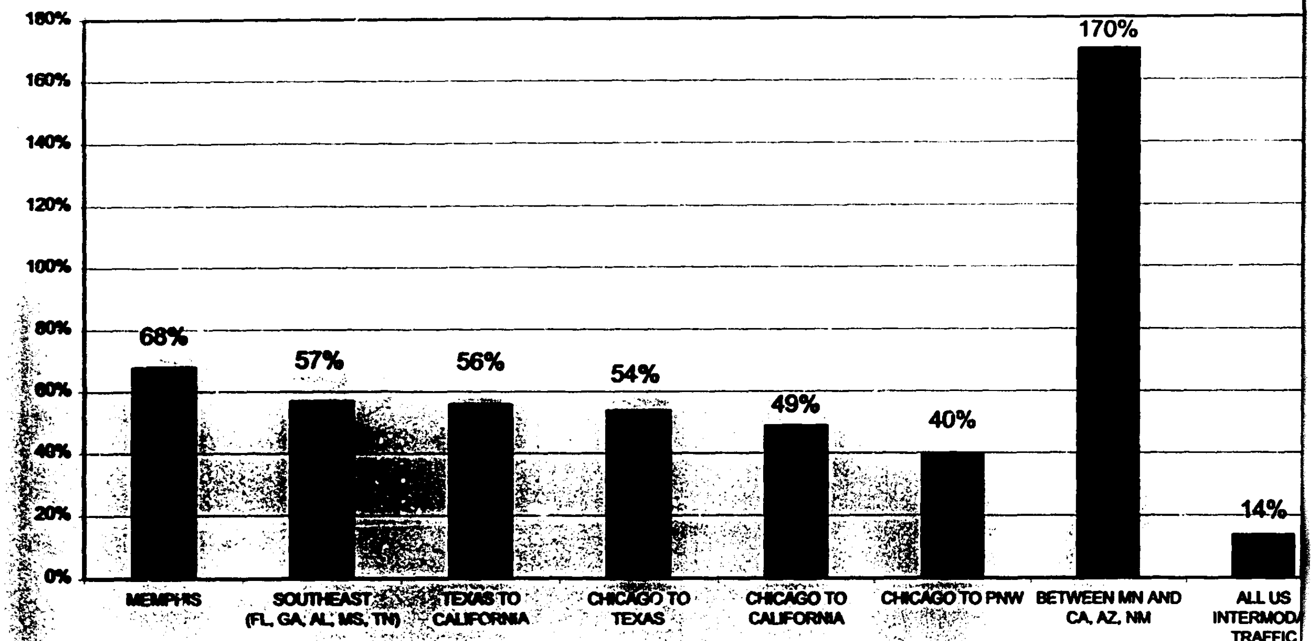
CLASS 1 RAILROAD PERFORMANCE: 1980 - 1999
(1980 = 100)



3 Real Dollars.
AR Railroad Facts 1984, 1986, 1999; AAR Railroad Ten-Year Trends 1984-1993, 1989 -1998; AAR
Class 1 Railroads, 1999; The Economic Report of the President, 2000.

Figure 2

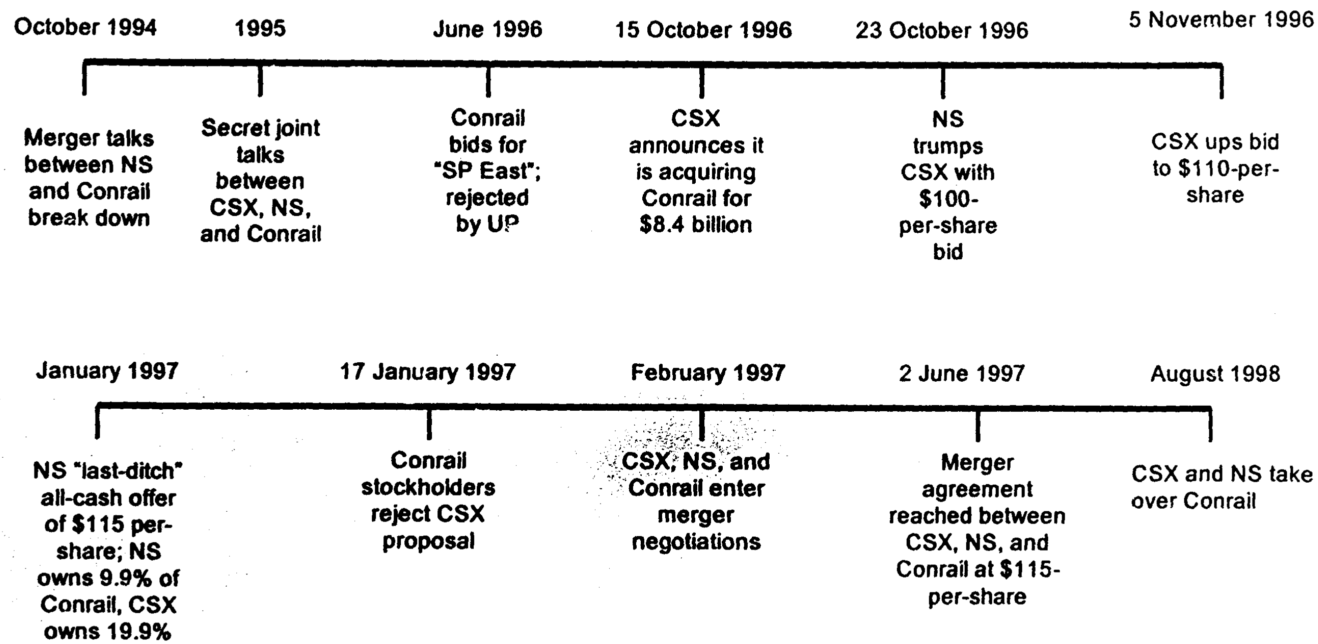
INCREASES IN BNSF INTERMODAL TRAFFIC ON SELECTED ROUTES, 1995-1999



rces: BNSF Quarterly Progress Report in Union Pacific and Southern Pacific General Oversight, January 18, 2000, Finance Docket No. 32760, at 35; Association of American Railroads, *Railroad Facts*, 1999, at 26.

Figure 3

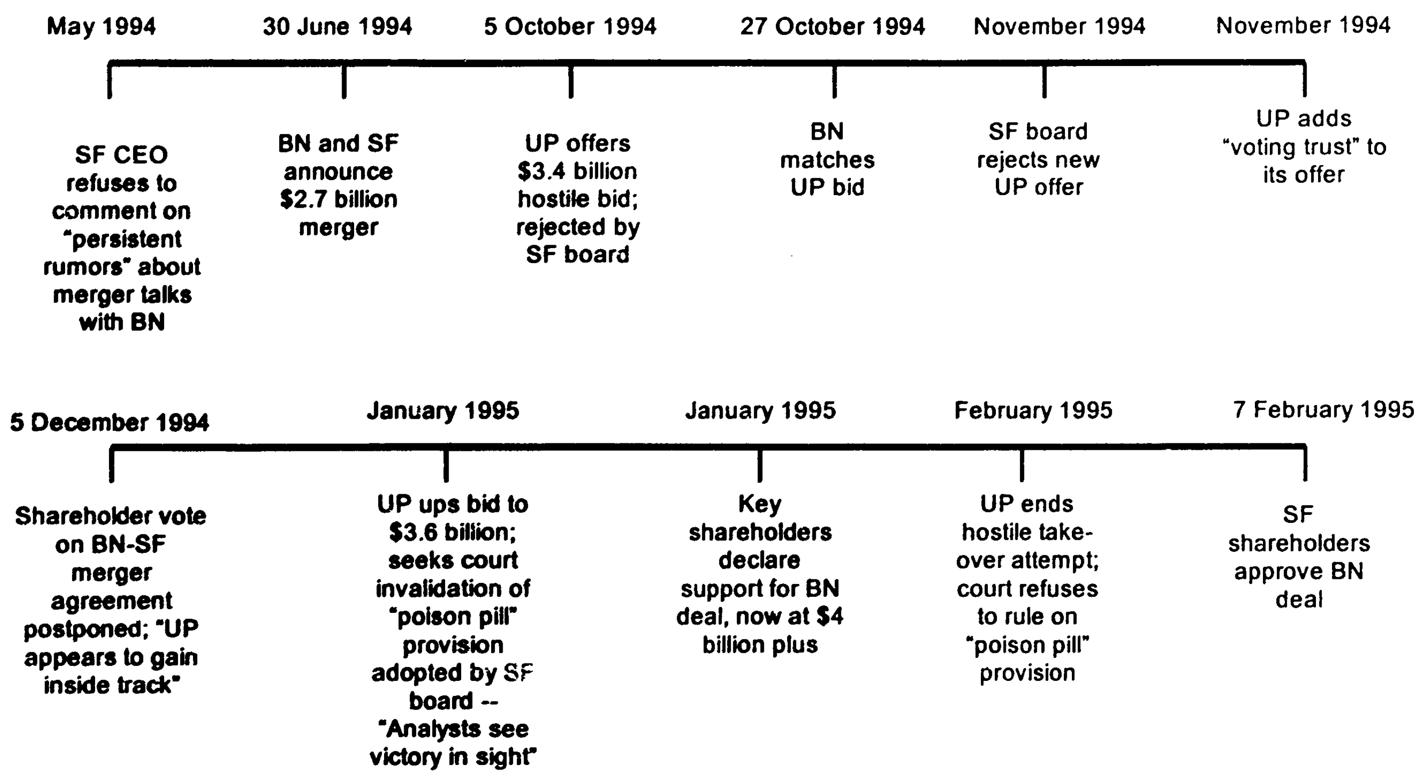
Conrail Transaction



Source: Trade Press; CSX press announcements

Figure 4

BNSF Merger



Source: Trade Press

VERIFICATION

I, José Gómez-Ibáñez, verify under penalty of perjury that the foregoing is true and correct. Further, I certify that I am qualified and authorized to file this Verified Statement.

Executed the 16th day of November, 2000.

José Gómez-Ibáñez

VERIFICATION

I, Joseph P. Kalt, verify under penalty of perjury that the foregoing is true and correct. Further, I certify that I am qualified and authorized to file this Verified Statement.

Executed the 16th day of November, 2000.

Joseph P. Kalt

BEFORE THE SURFACE TRANSPORTATION BOARD

EX PARTE 582 (SUB-NO. 1)

MAJOR RAIL CONSOLIDATION PROCEDURES

VERIFIED STATEMENT OF RICHARD J. PIERCE, JR.

My name is Richard J. Pierce, Jr. I am the Lyle T. Alverson Research Professor of Law at George Washington University, 720 20th Street, N.W., Washington, D.C. 20052. I have been asked by The Burlington Northern and Santa Fe Railway Company (BNSF) to provide my opinions on the new rail merger policy the Surface Transportation Board (STB or Board) proposed in Ex Parte No. 582 (Sub-No. 1). I will begin by describing my background and experience relevant to that task. I then will summarize the history of economic regulation, deregulation, and regulatory reform in the U.S. over the last three decades. I will follow that with a description of the merger policies currently implemented by other agencies, with emphasis on the current policy of the Federal Energy Regulatory Commission (FERC), an agency that, like the STB, applies a public interest standard, rather than pure antitrust review. After that, I will identify the characteristics of the STB's proposed policy that I believe to be inappropriate, counterproductive, and a major step backward from the regulatory reform efforts that have produced outstanding results in numerous markets, including the rail market, over the past 30 years.

I conclude that any final rules adopted by the STB should: (i) result in timely review of mergers; (ii) eliminate the presumption that future rail mergers will not produce efficiencies; and

(iii) eliminate the presumptions that future rail mergers will produce competitive harms and service disruptions. The STB should not require merger applicants to propose "competitive enhancements" to offset presumed harms, and the scope of post-merger review should be limited to the efficacy of competitive conditions adopted in the merger and the temporary remedy of any merger-related service disruptions.

BACKGROUND AND EXPERIENCE

I have been a law professor for 23 years. The courses I regularly teach include Regulated Industries, Antitrust Law, and Administrative Law. My research and scholarly writings correspond with the subjects I teach. I have written a dozen books and over 80 articles. I have attached a copy of my resume, including a list of my publications, as Appendix A to this report. My central interest in teaching, research, and writing is the effects of various forms of government intervention – including economic regulation and antitrust law – on the performance of markets. My writings have been relied upon by numerous agencies and courts, and are found in many opinions of the U.S. Supreme Court. I have played an active role in the process of restructuring, and reforming the regulation of, many markets in North America, Europe, Asia, and Australia. In addition, I have provided consulting services to a wide variety of private and governmental participants in those processes of restructuring and regulatory reform, including the General Accounting Office, the U.S. Agency for International Development, the Organization for Economic Coordination and Development, and The World Bank.

THE RECENT HISTORY OF ECONOMIC REGULATION

In the early 1970's, the U.S. relied primarily on economic regulation to govern the performance of many markets, including rail, trucking, air travel, financial services, natural gas, electricity, oil and petroleum products, and telecommunications. Regulatory agencies used a combination of rate regulation and regulatory restrictions on market entry and exit to implement a system of central planning. All of those regulated markets performed poorly.

The U.S. responded by deregulating the markets that were not characterized by natural monopoly conditions – specifically, trucking, airlines, oil and petroleum products, and financial services. The results were so socially beneficial that the U.S. turned its attention to markets with more complicated characteristics. The natural gas, telecommunications, and electricity markets include many functions that are susceptible to performance in an unregulated, structurally competitive market, but they also include some functions, like transmission of electricity, that continue to be natural monopolies. In each of these markets, the U.S. has reduced significantly the role of government regulation as a governance mechanism, and has increased its reliance on unregulated competitive market forces to obtain socially beneficial changes in the performance of the markets. Generally, the U.S. has separated the natural monopoly functions from the functions that are susceptible to governance by competitive markets, deregulated the functions that are susceptible to performance in a competitive market, and switched to new methods of regulating the residual natural monopoly functions that are compatible with, and supportive of, the newly deregulated market-based functions.

The results have been impressive. Each of these markets performs much better today than it did when we attempted to rely on central planning and pervasive regulation to govern it. As scholars from the Brookings Institution and George Mason University concluded in an important study published in 1997, consumers have obtained scores of billions of dollars in annual benefits as a result of this movement toward deregulation and regulatory reform. Robert Crandall & Jerry Ellig, Economic Deregulation and Consumer Choice (1997). I have described this process and its many socially beneficial results at greater length and in greater detail elsewhere. See, e.g., Richard J. Pierce, Jr. & Ernest Gellhorn, Regulated Industries (4th ed. 1999); Richard J. Pierce, Jr., Economic Regulation (1994); Richard J. Pierce, Jr., Reconstituting the Natural Gas Industry from Wellhead to Burnertip, 9 Energy L. J. 1 (1988).

The extraordinary success of the U.S. deregulation and regulatory reform process, combined with the enviable performance of the U.S. economy and the collapse of the centrally planned Soviet economy, has inspired nations on every continent to emulate the U.S. approach. Almost every country is in some stage of attempting to apply the lessons of the U.S. movement toward deregulation and regulatory reform, with the same kind of resulting substantial improvements in market performance that the U.S. has experienced.

As the Board well knows, the history of the U.S. rail industry is similar to the history of the other industries that have been the subject of deregulation and regulatory reform. In the early 1970s, the U.S. rail market was on the verge of total collapse. Most railroads were either bankrupt or nearly so. The cause was easy to identify. Implementation of a central planning approach to the market through application of rate regulation and regulatory restrictions on market entry and exit had nearly destroyed the market. The rail regulatory regime that was being implemented at the time cost the U.S. economy between $9.7 and $16.2 billion per year. C. Barnekov & A. Kleit, The Costs of Railroad Regulation (1988).

Congress responded by enacting the 4R Act and the Staggers Act. As they were ultimately implemented by first the ICC and then the STB, those statutes went a great distance toward replacing central planning with reliance on markets to determine prices, terms and conditions of service, and market entry and exit. Those statutes were predicated on the well-supported belief that railroads confront effective competition in most markets from a combination of other railroads and other modes of transportation. The STB continues to perform some important regulatory roles, e.g., regulation of rates charged where a railroad has "market dominance." Even in those narrow contexts, however, the STB has come increasingly to rely on regulatory methods that reflect market forces, e.g., differential or Ramsey pricing, rather than traditional cost-of-service regulation. As a result, the rail market is much healthier than it was prior to the regulatory changes mandated by Congress. By any conceivable measure, shippers and the U.S. economy have experienced significant benefits attributable to the movement from primary reliance on regulation to primary reliance on market forces to govern the rail market.

The Board's revised merger policy should reflect these general and rail-specific directions in economic regulation.

MERGER POLICY

Any country needs a merger policy that accomplishes two goals. First, it should enable an agency to identify, and potentially to block, proposed mergers that would have the potential to create unacceptable anticompetitive effects. Second, it should enable all other proposed mergers to be reviewed and approved quickly and easily. We often tend to emphasize the first goal in talking about merger policy, but the second goal is even more important than the first. Only a small fraction of proposed mergers pose any plausible threat of harm to the performance of any market. The vast bulk pose no such threat. In an economy as diverse and dynamic as the U.S. economy, it is essential that firms be able to order, and to reorder, their structures and relationships quickly and easily in response to constantly changing marketplaces.

The U.S. legal regime applicable to most mergers furthers both goals admirably. In most areas, the Department of Justice and the Federal Trade Commission (DOJ/FTC) share responsibility to determine whether a proposed merger is likely to have intolerable anticompetitive effects and to attempt to block any such merger that they so identify. They fulfill those responsibilities in a highly pragmatic manner that has helped to give the U.S. the best performing economy in the world. A high proportion of proposed mergers do not even meet the threshold criteria that trigger a duty to notify the DOJ/FTC of the merger. Of those that do, the DOJ/FTC attempt to block only a handful of proposed mergers each year. A high proportion of the proposed mergers that do meet those criteria elicit only a quick review by the DOJ/FTC that is sufficient to allow them to conclude that the merger poses no plausible threat to harm the performance of any market. The DOJ/FTC identify only a small fraction of proposed mergers that raise plausible concerns sufficient to justify detailed scrutiny. Even within that small class of proposed mergers, in most cases the DOJ/FTC ultimately conclude either that the proposed merger does not, in fact, threaten competitive harm or that any such threat can be mitigated adequately through undertakings that the firms are willing to make as conditions on the DOJ/FTC's acquiescence in the proposed merger. Through this process, the vast majority of proposed mergers in the U.S. are completed quickly and inexpensively. In most cases, the DOJ/FTC complete the process of reviewing a proposed merger within sixty days. Thus, as it is designed and implemented, U.S. merger policy reflects a presumption that most mergers are socially beneficial. That presumption can be rebutted only by demonstrating that a proposed merger has the clear potential to harm the performance of a market.

It is even more important to have a merger policy that allows mergers to be completed quickly and inexpensively in the context of a previously regulated market that is undergoing a transition to greater reliance on market forces. Regulation always distorts firms' decisionmaking and induces firms to choose inefficient structures. It also distorts their decisionmaking in many other contexts, e.g., it induces them to make poor investment decisions, to invest in the wrong kinds of assets in the wrong places, to hire the wrong numbers and types of personnel, and to make other decisions based on regulation, rather than economic efficiency. When previously regulated firms are freed from regulatory restraints and subjected instead to competitive market forces, they invariably conclude that they must make major changes in order to be efficient enough to survive and prosper in their new environment. Many discover that they must make major structural changes through mergers and acquisitions. Any agency that is responsible for considering proposed mergers in that context must adopt a merger policy that will both allow it to identify, and to block, the occasional proposed merger that poses intolerable risks of harm to the performance of markets, and, even more important, allow the quick and inexpensive consummation of the many mergers that do not pose such risks.

Of course, regulatory agencies review mergers under a "public interest" standard that is not necessarily the same as the antitrust analysis performed by the DOJ/FTC. However, even in this area, regulators have, over time, narrowed the scope of their review considerably.

For example, FERC has jurisdiction over mergers in the electric utility industry, an industry that is undergoing a transition from pervasive regulation to primary reliance on competitive market forces. FERC originally used a six-factor test for merger review: (1) the effect of the proposed merger on competition; (2) the effect of the proposed merger on the applicants' operating costs and rate levels; (3) the reasonableness of the purchase price; (4) the degree of coercion, if any, the acquiring utility has applied to the to-be-acquired utility to accept the merger; (5) the impact of the merger on state and federal regulation; and (6) the contemplated accounting treatment. In a high proportion of cases, FERC applied that policy through the use of lengthy oral adjudicatory hearings.

However, in 1996, FERC concluded that its policy was no longer appropriate for application to an industry that was undergoing a transition to primary reliance on market forces, and announced a new policy that was designed to fit the new environment. See FERC Order No. 592, Docket No. RM96-6-000 (Dec. 18, 1996) (policy statement) and Order No. 592-A, Docket No. RM96-6-001 (June 2, 1997) (order on reconsideration); FERC Order No. 642, 93 F.E.R.C. ¶61.164 (November 15, 2000). See also Richard J. Pierce, Jr., Antitrust Policy in the New Electricity Industry, 17 Energy L. J. 29 (1996).

In justifying its changed policy, FERC identified several major defects in its old policy, each of which also is relevant to the Board's proposed revisions to its merger policy. First, many of the factors it considered were not appropriate for consideration by an agency that was reviewing mergers proposed by firms that are subject to market forces. Second, FERC concluded that its old policy was too unpredictable in its outcome, imposed undue burdens, and required far too much time to implement in many cases. FERC recognized that most proposed mergers are socially beneficial, and that a policy that is difficult to predict, burdensome, and slow deters many firms from even attempting to enter into socially beneficial mergers. Third, FERC recognized that its old policy was highly susceptible to abuse by badly motivated protestors and intervenors. Those included competitors who wanted to stop, or at least to delay, a transaction that would create a more formidable competitor, and rent seekers who used their ability to protest, or to demand a costly hearing, as a source of leverage to extract from the merging firms a variety of special interest concessions on issues unrelated to the proposed merger. Fourth, FERC recognized that its old policy tended to discount and to submerge the issue that should dominate its merger policy in the new environment – whether a proposed merger is likely to cause serious harm to the performance of any market.

To remedy these problems, FERC's new policy reduced to three the factors that FERC will consider in acting on a proposed merger: (1) effects on competition; (2) effects on rates;

and (3) effects on regulation. As a practical matter, FERC places almost exclusive emphasis on effects on competition in most cases. In applying the first factor – effects on competition – FERC has largely adopted the DOJ/FTC Merger Guidelines. This enables FERC to screen proposed mergers, so that mergers that do not raise significant competitive issues can be handled on an expedited basis. The second factor – effects on rates – is unique to FERC's method of ratemaking. It usually can be satisfied simply by applicants agreeing not to file for rate increases directly attributable to the merger. The third factor – effects on regulation – reflects potential jurisdictional problems that sometimes are raised by a merger as a result of some judicial interpretations of the Public Utility Holding Company Act. Those opinions suggest that some utility mergers can have the effect of precluding both FERC and state regulators from regulating transactions among corporate affiliates. That factor usually can be satisfied simply by applicants agreeing not to use the merger as a vehicle to avoid state or FERC regulation of matters that were subject to state or FERC regulation before the merger.

FERC's revised policy had positive results. FERC has applied its new policy to 42 proposed mergers in the last four years, excluding the few merger applications that were filed and withdrawn when the applicants changed their minds about the desirability of the proposed merger. See List of Mergers Filed with the Commission Since 1995, available at http://www.ferc.fed.us./electric/mergers/mgrpag.htm (last updated July 31, 2000). FERC approved each of these mergers, though it approved some on the condition that the parties adopt mitigating measures. FERC completed its review and approval process in less than six months in 37 of the 42 cases, and its average processing for merger applications has been 117 days since it revised its policy. It completed the process in less than a year in all but one of the cases. That case raised extremely difficult and unprecedented issues. Even in those cases where competition issues were raised, FERC has been able to resolve most mergers on the basis of the filing submitted by the merger applicants, pleadings filed by interested parties, and supplemental data requests from its staff. Most mergers handled by FERC do not result in formal discovery by the parties and are resolved through "paper hearings," without the use of formal discovery or evidentiary hearings. Courts have repeatedly upheld and often applauded this type of decisionmaking procedure by agencies that are acting under broader statutory standards in cases in which the dominant issues are economic. See, e.g., Louisiana Energy and Power Authority v. FERC, 141 F.3d 364 (D.C. Cir. 1998); Union Pacific Fuels v. FERC, 129 F.3d 157 (D.C.Cir. 1997); SBC Communications v. FCC, 56 F.3d 1484 (D.C. Cir. 1995). See generally Kenneth Culp Davis & Richard J. Pierce, Jr., Administrative Law Treatise § 8.2 (3d ed. 1994 and annual supplements). The advantages of this procedure are obvious and substantial. It permits the agency to make decisions on the basis of high quality data and analysis with limited consumption of agency resources. It expedites the decisionmaking process. It also reduces the ability of third parties to abuse the merger review process by using it to block or to delay a competitor's merger or to extract special interest benefits by threatening to try to block the merger or to delay the proceeding.

FERC's policy has, over time, moved toward the focused approach used by the DOJ/FTC and other agencies that are engaged solely in antitrust review. Under this approach, the agency first defines the appropriate markets and the effects on those markets of the proposed merger. If the agency identifies a market in which it fears that the merger creates an undue risk of harming the performance of the market, it works with the applicants to identify an effective means of mitigating the potential harm it has identified. In a high proportion of the relatively few cases that reach this stage of the decisionmaking process, the agency is able to identify effective mitigation measures that the firm is willing to implement as a condition on the completion of its merger, e.g., divestiture of assets in a market in which the merged firm otherwise would have an unduly high share of the market. If the agency identifies a market in which the merger poses a significant risk of anticompetitive behavior that is not amenable to effective mitigation, the agency looks at the potential social benefits of the merger to determine whether they are sufficient to justify its approval notwithstanding the existence of some risk that the merger might harm the performance of some market. These are the relatively rare hard cases that sometimes elicit an order disapproving a proposed merger.

One characteristic of this decisionmaking process is particularly noteworthy. Each step is contingent on the results of the prior step. Thus, for instance, the agency does not engage in detailed economic analysis unless and until it has applied some simple screens to see whether such an analysis is necessary. It does not look for mitigation measures unless and until it has concluded that the merger would pose an undue risk to the performance of a market in the absence of mitigation measures. It does not look for social benefits of a merger unless and until it concludes that the merger poses otherwise unacceptable and unmitigatable risks to the performance of a market.

This clear, simple, contingent, and sequential approach has many advantages. It conserves the resources of the agency and the parties. It minimizes the amount of time required to review a proposed merger. Finally, it permits any firm that is considering a potential transaction to perform its own analysis early in its own decisionmaking process and to make a reasonably reliable prediction of the likely results of the agency's decisionmaking process.

Following this general trend, the Board's final merger rules should focus principally on competitive issues, with additional review of issues that are unique to the rail industry, such as service issues. A narrow scope of review, coupled with expedited review, would be consistent with the Board's application of a broad "public interest" standard.

THE STB'S PROPOSED POLICY

The STB is wise to reconsider its merger policy to determine whether conditions have changed in the past twenty years in ways that justify a change in policy and to reflect the general trends in the area of economic regulation. The proposed new policy is severely flawed in a number of respects, however. Before I discuss each of the elements of the proposed policy that are inappropriate and counterproductive, I will describe the problems that would be created by adoption of the policy as a whole.

The proposed policy would require the STB to apply at least four factors in addition to the potential adverse effect on competition in evaluating a proposed merger: (1) the adequacy of the firms' plan to improve service; (2) the adequacy of the firms' plan to enhance competition; (3) the adequacy of the firms' plan to minimize service disruptions during the post-merger transition period; and (4) the adequacy of the firms' attempt to anticipate and then to evaluate the likely responses of the firms' competitors to the proposed merger, including additional mergers that might be proposed as a competitive response to the proposed merger. The inclusion of "enhanced competition" and downstream effects in this analysis would impose extraordinarily heavy burdens on both the applicants and the STB's staff. It would produce long, expensive, and complicated proceedings. It would maximize the opportunities for competitors and other third parties to abuse the merger approval process by using it to stop or to delay a pro-competitive merger or to use it as a means to extract special favors unrelated to the proposed merger. It would require the STB to select winners and losers if it adopts remedies or conditions that are not specifically designed to offset identified harms. Finally, the use of such factors in reviewing mergers would render prediction of the likely results of the merger review process nearly impossible. Through each of those effects, the proposed policy would deter firms from even attempting to identify, negotiate, and propose socially beneficial mergers.

The factors beyond competitive and service effects that the STB has proposed also represent a major step back to the bad old days in which agencies acted on the assumption that agency-implemented central planning will yield better results than primary reliance on market forces to determine the most efficient structure of a market. As stated in the recently released "Final Report of The International Competition Policy Advisory Committee to the Attorney General and Assistant Attorney General for Antitrust" (2000) [hereinafter Attorney General's Advisory Committee, available at www.usdoj.gov.atr/icpac/icpac.htm]:

> As a best practice or discipline, with limited exceptions (such as national security), noncompetition factors should not be applied in antitrust merger review. If a jurisdiction's law recognizes noncompetition factors (such as preservation of jobs, promotion of exports, or international comparative advantage), such factors should be applied transparently and in a manner narrowly tailored to achieve their ends. *Executive Summary*, Attorney General's Advisory Committee.

While the Board reviews mergers under a public interest standard, the analysis of merger-related competitive effects should, for reasons discussed above, be the core of that analysis. Moreover, the Board's proposed policy would reduce the transparency of its decisions and expand the scope of its review and remedies.

I will now discuss each of the factors the STB proposes to apply in reviewing proposed mergers.

Presumption That All of the Efficiency Enhancing Mergers Have Been Completed

The Board's proposed "paradigm" shift in merger policy review is premised on the unprecedented and unsupported presumption that the rationalization of the nation's rail system and the elimination of excess capacity have been completed. Specifically, the Board cites substantial reductions in excess capacity and improvements in efficiency that have resulted from the prior rail mergers that rationalized the nation's rail system, and then concludes that "this process has now largely been completed, and [] the efficiencies and service improvements to be realized from further downsizing of rail route systems are limited." Comments to Proposed § 1180.1(a), Notice of Proposed Rulemaking (NPR) at 11.

To my knowledge, no agency has ever announced a merger policy that presumes that future mergers are unlikely to improve the performance of a market. The STB reasons that, since prior mergers yielded large efficiency gains, future mergers are unlikely to produce significant further improvements. That is a classic non sequitur. The STB provides no support for its belief, and it is hard to imagine how any agency could support such a belief. It is highly unlikely that any market in history has been characterized by optimal structural efficiency. If any market ever reached that state of structural euphoria, that state would exist only for a very short time. The U.S. economy is extraordinarily dynamic. Firms in every market must engage in a continuous process of reevaluating their structure to determine whether it continues to allow them to participate in constantly changing markets in an efficient manner.

The Presumption of Anticompetitive Effects

The Board has also proposed to adopt a presumption that any proposed merger of Class I railroads would have anticompetitive effects. Thus, the Board says that "[a]ny railroad combination entails a risk that the merged carrier will acquire and exploit increased market power." Proposed § 1180.1(c)(2)(i), NPR at 15. In another place, the Board says that it "expects that any merger of Class I carriers will create some anticompetitive effects . . . ." Proposed § 1180.1(d), NPR at 16. That presumption seems to drive many of the other elements of the

Board's proposed policy. Thus, for instance, because mergers would have anticompetitive effects, the Board says that it "does not favor consolidations . . . unless there are substantial and demonstrable public benefits to the transaction that cannot otherwise be achieved." Comments to Proposed § 1180.1(a), NPR at 11.

A presumption that an entire class of potential mergers will have anticompetitive effects is again unprecedented and unsupportable. There are over 120 merger policies currently in effect around the world. To the best of my knowledge, none of those policies includes a presumption that an entire class of mergers will have anticompetitive effects. The Board has provided no support for this presumption.

Some proposed mergers pose significant risks that they will impair the performance of one or more markets. Others do not. The only way to distinguish among them is to apply standard tools of economic analysis to each market that is potentially affected by a specific proposed merger. The Board can fulfill its responsibilities in the merger review process only by identifying each product and geographic market that is potentially affected by a proposed merger and evaluating the potential effects of the merger on the performance of each of those markets.

Presumption of Significant Service Disruptions

The Board discusses at length its concerns about potential service disruptions during the period following a merger. It then adopts a presumption that rail mergers will necessarily create substantial service disruptions. It says: "Our recent experience has shown that, even with substantial advance planning, implementing large rail mergers may cause substantial service disruptions that delay or outweigh expected efficiency gains that should flow to the public. Under our proposed rule, these potential harms would be included in our balancing test." Comments to Proposed § 1180.1(c), NPR at 13.

However, only some of the most recent consolidations produced those unfortunate results. Two cases are not sufficient to support a sweeping generalization, particularly when those two cases involved unusual factors and when there are numerous cases in which mergers did not yield serious service disruptions. There is no justification for a presumption that rail mergers will cause substantial service disruptions, particularly when the Board also is proposing that merger applicants address their transitional plans with a new level of detail and that a heightened regime of post-merger monitoring of service be implemented.

Moreover, merger applicants will have every incentive to minimize service disruptions in the future. Markets punish firms severely for service disruptions. The financial performance of UP during the period in which it experienced severe service problems illustrates the point. During its service crisis, UP's quarterly earnings per share dropped from $0.96 in September 1997 to a low of a <u>loss</u> of $1.70 per share in June, 1998. UP's earnings did not recover until the second half of 1999. UP was hit with several lawsuits, and the STB imposed emergency service orders on UP during the depths of its crisis. UP's experience serves as an effective object lesson to other firms that might otherwise be tempted to try to implement a merger with inadequate planning.

Because the Board believes that the risk of service disruptions is serious enough to warrant consideration in merger review proceedings, it clearly can require applicants to submit their plans to avoid those problems for the Board's review, as the Board has proposed. (I understand that BNSF supports this requirement.) However, the Board should then limit its consideration of the proposed plan to avoid service disruptions to a simple yes or no determination with respect to the adequacy of the plan. It should not attempt to assign a value to the risk of service disruptions that must then be offset with unrelated enhancements. That is the antithesis of the "transparent" and "narrowly tailored" consideration of noncompetition factors recommended by the Attorney General's Advisory Committee.

Mandatory "Enhanced Competition" Conditions

The Board proposes "to require applicants to incorporate proposals for enhanced competition . . . ." Comments to Proposed § 1180.1(c), NPR at 13. The Board refers to an "equal access" rule as an example of such a mandatory proposal. It also says that inclusion of such a proposal is "likely to be extremely important to us in determining whether to approve a particular application." Id. at 14. This is a bad idea for at least four reasons.

First, if the Board is convinced that some major change in its regulatory policy, like an equal access requirement, would yield significant public benefits, the efficacy of that policy change will depend primarily on its scope. It would make little sense, and do little good, to impose it selectively on railroads that propose to merge. Instead, the agency should consider whether to apply the new approach to all railroads.

Second, adopting a policy of approving mergers only if the applicants agree to adopt a major change in their methods of operation that they consider highly undesirable is much more likely to discourage railroads from proposing socially beneficial mergers than to produce a legal regime in which many railroads agree to the change as a condition of approval of a merger.

Third, the policy would require the Board to determine what level of enhancements are necessary to offset possible harms and then allocate those enhancements to shippers who are not, by definition, directly affected by the potential harm. The unfairness inherent in providing benefits to one class of shippers, rather than another, is a key reason why remedies should be designed to offset specified harms to specific groups.

Fourth, and most important, no agency should consider adopting a major change in its regulatory policy, like an equal access rule, without considering carefully and in detail all of the implications and effects of adopting the new policy. That cannot be done as an add-on to a merger review proceeding. It requires instead a separate rulemaking in which the agency addresses with care the scores of important issues that are raised by such a proposed policy change.

Requiring only one participant in a market to allow its competitors to use its assets is a radical step. In the vast majority of circumstances, this would be a terrible idea, whether or not open access or similar regimes would be beneficial if implemented on a broad basis.

Mandatory Post-Merger Oversight

The Board proposes to establish an elaborate "formal oversight process" applicable to all mergers. Proposed § 1180.1(g), NPR at 19; see also Proposed § 1180.1(i), NPR at 20. Because the Board's review extends beyond the efficacy of any competition-related merger conditions and merger-related service problems to include unforeseen circumstances, subsequent mergers, and conditions related to the achievement of all projected benefits exactly when projected, this proposal would undercut the transparency and finality that is required in merger proceedings. Indeed, unless the scope of post-merger review is properly limited to the efficacy of the competitive remedies adopted in the merger and the identification and resolution of merger-related service problems, I cannot imagine any firm that would be willing to propose a merger that would be subject to such an extraordinary, open-ended post-merger oversight process and subject to the risk of after-the-fact imposition of new, impossible-to-predict conditions.

The Board's proposal would vastly expand the scope of post-merger review beyond that undertaken by other agencies. Agencies sometimes approve mergers subject to mitigation conditions, e.g., divest fifty percent of your retail gasoline outlets in Los Angeles. Agencies act in that manner when they conclude that a proposed merger would have unacceptable effects on the performance of a market in the absence of the mitigation condition. When an agency approves a merger subject to a mitigation condition, it retains the power to enforce the condition, or even to dissolve the merger, if the merged firm fails to comply with the condition. All merger applicants understand and accept the need for an agency to retain that power. The applicants know what the mitigation conditions on approval are before they merge. If they conclude that the conditions are unacceptable, they simply decline to merge. I have never heard of any agency attempting to retain an open-ended power to impose new conditions on a previously approved and completed merger based on the agency's determination that the merger has not produced exactly the results that the applicants expected or that the agency later prefers.

First, as I noted earlier, under the proper scope of review in today's economy, the Board should not require submission of evidence that a merger will produce benefits unless it concludes that the merger poses a significant risk of adversely affecting the performance of a market and that risk cannot be effectively mitigated. However, I understand that this is an accepted practice in the rail industry, even without the expansion the Board is currently providing. Nonetheless, an agency certainly should not attempt to engage in post-merger oversight to ensure that the merger produced precisely the benefits the applicants projected.

Second, it would be extremely difficult to determine whether any "shortfall" in benefits is a result of the problems relating to the merger. The performance of any firm depends on a myriad variables, many of which are beyond the firm's control. If a merged firm's performance falls short of its expectations and those of the Board, the Board would have to determine the extent to which its performance is attributable to the merger versus the extent to which it is attributable to any number of other potential sources, e.g., an economic downturn, the responses of competitors, an increase in fuel or labor costs, or a tightening of capital markets.

Third, no transaction ever goes exactly as planned or as the parties anticipated that it would. That basic truth certainly applies to all mergers. I doubt that any merger in history has produced exactly the results the firm expected. The results of a merger depend on how it interacts with numerous other factors, including changes in market conditions, responses of competitors, and changes in general economic conditions. Sometimes a merger produces benefits that differ significantly from the firm's expectations. Thus, for instance, a firm might project large savings in labor costs, but unexpected increases in demand for the firm's services might persuade it to retain its original workforce and to reassign many of its employees in ways that permit it to meet the increased demand efficiently and effectively. Would the Board consider that a failure to fulfill the firm's benefit projections? Would it order the firm to fire enough employees to fulfill its original projected labor cost savings? Some mergers produce disappointing results – results that fall well short of the firm's expectations. Agencies do not approve mergers because they expect all mergers to be successful. Such an expectation would be absurd. It is contradicted by history. Some mergers yield spectacular results; some yield terrible results. Agencies approve mergers that do not have anticompetitive effects because they know that many will yield good results and because they know that the firms that propose to merge are in a much better position than any agency to predict the results of the merger.

Fourth, and most important, unless the scope of post-merger is properly limited, I cannot imagine any firm that would be willing to merge, or even to consider a merger, under conditions in which an agency can impose unknown and unknowable conditions on the merged firm years after the merger is approved and implemented.

Requirement to Anticipate and to Analyze Responses of Competitors

The proposed policy would require merger applicants to predict the responses of their competitors, including any mergers their competitors might propose in an effort to remain competitive with the merged firm, and to evaluate the effects of those potential responses. The Board would then hold the applicants responsible for the effects of their competitors' responses by denying the application if the Board concludes that the competitors' responses would have unacceptable effects.

The Board should not adopt this policy. First, it is extremely difficult for a firm to predict the actions of its competitors with any degree of confidence and accuracy. Of course, firms attempt to do this all of the time, but they can never do better than to predict a relatively wide range of potential responses. Second, any firm is understandably reluctant to disclose to its competitors its evaluation of the likely effects of the range of actions it believes that its competitors might take. No agency should compel any firm to disclose that information. Markets do not perform well when competitors are required to share with each other their predictions and evaluations of their competitors' potential actions. Third, this requirement will force applicants to speculate and will make merger proceedings unmanageable. That is why the STB wisely refrained from imposing such a requirement in the past. Those reasons remain valid and persuasive today. Fourth, this requirement would provide competitors of merger applicants an ideal vehicle to abuse the merger review process by blocking a socially beneficial merger. The competitor would need only to allege that it would respond to the merger by proposing a patently outrageous merger in order to block approval of the proposed merger. Fifth, it makes no sense to disapprove an otherwise socially beneficial merger because it might induce a competitor to propose a socially destructive merger. If that happens, the Board should simply disapprove the second proposed merger.

CONCLUSION

The Board should not adopt those proposed changes in its merger policy that would expand the scope of its merger review or create new presumptions against mergers. Such changes would return the Board to a central planning role, threaten the transparency and predictability of Board review, and result in a mismatch of actual harms and actual remedies. The Board should maintain the approach that is clearly reflected in the 4R Act and the Staggers Act and that has produced excellent results in so many other markets. It should rely primarily on market forces to produce good results, and it should rely on regulation only in those few contexts in which market forces alone are unlikely to produce good results.

Therefore, any final rules adopted by the Board should: (i) eliminate the presumption that rail mergers will no longer produce public benefits; (ii) eliminate the presumptions that future rail mergers will cause competitive and service harms; and (iii) eliminate the requirement that merger applicants propose "competitive enhancements" to offset these presumed harms. Final rules also should not require applicants to "guarantee" the projected benefits of mergers or to forecast the responsive actions of their competitors. The Board's rule also should limit the scope of post-merger review to the efficacy of competition conditions adopted as part of the merger and the temporary remedy of merger-related service problems. Most importantly, any final merger rules should contain an expedited schedule and provide railroads and interested parties with transparency and finality in Board actions.

RICHARD J. PIERCE, JR.
122 Madison Place
Alexandria, Virginia 22314

Birthdate:	July 15, 1943
Married:	Jill Birdwhistell Pierce
Children:	Gabriel, 1974; Danielle, 1976

PRESENT POSITION: Lyle T. Alverson Research Professor of Law
George Washington University Law School
720 20th Street, N.W.
Washington, D.C. 20052
(202) 994-1549

COURSES:

Administrative Law, Antitrust Law, Regulated Industries, Energy Law, Oil and Gas Law, Energy Tax Policy, Evidence, Torts, Conflicts, Economic Analysis of Law

EMPLOYMENT:

June 1989 - June 1995 -	Paul J. Kellner Professor of Law Columbia University School of Law 435 West 116th Street New York, NY 10027-7297
June 1986 - June 1989 -	George W. Hutchison Professor of Energy Law Southern Methodist University School of Law Dallas, TX 75275
July 1984 - June 1986 -	Dean and Professor of Law University of Pittsburgh School of Law 3900 Forbes Avenue Pittsburgh, PA 15260
July 1981 - June 1984 -	W. R. Irby Professor of Law and Director, Energy Law Program Tulane University School of Law New Orleans, LA 70118
August 1980 - June 1981 -	Visiting Professor of Law University of Virginia School of Law Charlottesville, VA 22901

August 1977 - August 1981 -	Professor of Law University of Kansas School of Law Lawrence, KS 66045 (Associate Professor until June 1980)
June 1972 - August 1977 -	Sutherland, Asbill & Brennan 1666 K Street, N. W. Washington, D. C. 20006
May 1969 to Sept. 1969-	Instructor, United States Coast Guard Reserve Training Center Yorktown, VA 23690
May 1968 to May 1969 -	Assistant Chief, Aids to Navigation Branch U.S. Coast Guard District Headquarters 1520 Market Street St. Louis, MO 63103
June 1966 to May 1968 -	Operations Officer United States Coast Guard Cutter Sedge Cordova, AK 99501
February 1966 to June 1966	Officer Candidate School United States Coast Guard Reserve Training Center Yorktown, VA 23960
June 1965 to February 1966	Financial Management Trainee General Electric Company Switchgear Department 6901 Elmwood Avenue Philadelphia, PA 19142

EDUCATION:

September 1969 to June 1972 -	University of Virginia School of Law Charlottesville, VA 22901 J. D.: 1972 Managing Editor, Virginia Law Review Order of the Coif Michie Legal Writing Award Student Assistant to Prof. Richard Merrill

September 1961 to June 1965 -	Lehigh University Bethlehem, PA 18017 B.S.: Economics
September 1958 to June 1961 -	Harriton High School Rosemont, PA 19072

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VERIFICATION

I, Richard J. Pierce, Jr., verify under penalty of perjury under the laws of the United States that the foregoing is true and correct. Further, I certify that I am qualified and authorized to file this Verified Statement.

Executed on November 16, 2000.

Richard J. Pierce, Jr.

BEFORE THE
SURFACE TRANSPORTATION BOARD

EX PARTE NO. 582 (SUB-NO. 1)

MAJOR RAIL CONSOLIDATION PROCEDURES

VERIFIED STATEMENT OF BRADFORD CORNELL

Background and Qualifications

I am a Professor of Finance and Director of the Bank of America Research Center at the Anderson Graduate School of Management at the University of California, Los Angeles (UCLA). I earned my doctorate in Financial Economics from Stanford in 1975, and have held positions as a finance professor at the University of Arizona, University of Southern California, California Institute of Technology, and UCLA. At UCLA, I have twice served as Vice-Chairman of the Anderson School and have twice served as chairman of the finance department. I am a past Vice-President of the Western Finance Association. I am also a past director of both the American Finance Association and the Western Finance Association.

I have written more than 70 articles and two books on finance and securities, including *Corporate Valuation: Tools for Effective Appraisal and Decision-Making,* published by McGraw-Hill, and *The Equity Risk Premium and the Long-run Future of the Stock Market,* published by John Wiley. I have also served as an associate editor of numerous professional journals – including *The Journal of Finance, the Journal of Futures Markets,* *The Journal of Financial Research* and *The Journal of International Business* Studies – and I have served as a reviewer for nearly a dozen other professional journals. I have received prizes and grants for my research from the Chicago Board of Trade, the Chicago Mercantile Exchange and the Institute for Quantitative Research in Finance.

My background is described more fully in my *curriculum vitae*, which is attached hereto as Exhibit 1.

Factual Background

On October 3, 2000, the Surface Transportation Board ("Board") announced proposed modifications to its regulations at 49 CFR part 1180 governing proposals for major rail consolidations. According to the summary disseminated by the Board:

> These proposed new rules would substantially increase the burden on applicants to demonstrate that a proposed transaction is in the public interest, requiring them, among other things, to demonstrate that the transaction would enhance competition as an offset to negative impacts resulting from service disruptions and competitive harms likely to be caused by the merger.[1]

The Board is seeking public comment on these proposed modifications before they are codified. I have been asked by The Burlington Northern and Santa Fe Railway Company ("BNSF") to comment on these modifications with respect to the railroad industry's ability to invest in and maintain its operating assets while earning a sufficient return on those assets to cover its economic cost of capital over the long term.

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[1] STB Ex Parte No. 582 (Sub-No. 1), Major Rail Consolidation Procedures (served October 3, 2000) ("NPR"), p. 1.

In the text of proposed 49 CFR 1180.1(a)-(d), the Board appears to presume that any merger between Class I railroad companies results in harm in the form of reduced competition and disruption in service. The merging parties must show that, as an offset to the presumptive harm caused by reduced competition and service disruption, the proposed merger offers "competitive enhancements." Furthermore, the Board would require the merging parties to project the public benefits of the proposed merger and suggest possible remedial steps for the Board to take if those benefits are not realized.[2] The merging parties would also be required to anticipate additional Class I merger applications that might be filed in response to their own application, to measure their benefits in light of the anticipated downstream mergers, and to discuss how conditions imposed in their proposed merger would have to be altered, or new conditions imposed, if any future consolidation(s) were approved.[3] Before the proposed merger would be allowed to proceed, there would be a lengthy review process: (i) a minimum notice period of three months, (ii) an application acceptance period of one month, (iii) an evidentiary proceeding lasting a year, and (iv) a final decision period of three months.[4] Thus, a proposed combination between two Class I railroad companies may be delayed for up to 19 months.

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[2] Proposed 49 CFR 1180.1(a)-(d), NPR pp. 11-16.

[3] Proposed 49 CFR 1180.1(i), NPR p. 20.

[4] Proposed 49 CFR 1180.4 (e) (2)-(3), NPR p. 27; 49 CFR 1180.4(b)(1) and (c)(7).

Discussion

As a general matter, anything that creates additional investor uncertainty and/or limits the ability of a firm's managers to utilize its assets in a manner that it feels is consistent with the interest of the stockholders adversely affects the firm's stock price and its cost of capital. The Board's proposed merger rules could have significant adverse effects on railroad investment incentives and the terms on which outside investors will continue to provide funds to the industry. The business of railroading is highly capital-intensive and requires billions in annual investment of private capital. Despite the important financial strides the industry has made under deregulation, it has yet to earn a sufficient return on its investment, according to accounting data published by the Board itself.

Regulatory limitations on the railroads' use of their assets effectively function as a tax, reducing the expected return on the assets. Delay in the approval process is particularly insidious from a financial standpoint. Not only does it delay the cash benefits of the merger, thereby significantly reducing the present value of the transaction, but it prevents the railroads that plan to merge from determining their optimal capital expenditure levels and allocation of assets while they are enmeshed in regulatory limbo. Investors do not look kindly on such delay, and they will lower their earnings expectations commensurately. The fundamental question that the Board must answer is whether the proposed changes will, in fact, add delay and increase uncertainty. If they do either, then the value of railroad assets will fall and the incentive to invest in railroad assets will decrease.

Even when mergers offer railroads the opportunity to use their assets more efficiently and do not diminish competition, the proposed merger rules require that the merging parties offer "competitive enhancements," which can significantly reduce the return promised by the merger. If, as here, the rules create significant uncertainty – not only about the level of "competitive enhancements" required, but also about whether new or revised conditions may be imposed in the future, and "measures" may be taken if all public benefits are not realized – the perceived risk significantly increases the cost of capital for the merging parties. Prospective investors will recognize that a railroad's ability to take advantage of merger opportunities that could help it cover its system costs is significantly diminished.

A rational response to such a regulatory tax, in order to protect shareholder value, is to shelve promising merger plans and scale back to projects, if any, that can be expected to earn the cost of capital. If the existing rail system as a whole does not hold out the promise of such returns, the railroads cannot be expected to continue making investments designed to maintain their overall capacity. They can be expected to make targeted investments in lines and services that offer the necessary returns and, over time, disinvest in the rest.

Railroad Industry Performance Under Deregulation. Freight railroads in this country are like other private businesses in that they must offer a competitive return on investment in order to attract and retain capital. It was largely because of the railroads' inability to attract and retain capital under regulation, with returns falling well below the returns of other U.S. corporations, that the industry was substantially deregulated in the late 1970's and early 1980's.[5] One of the most significant aspects of the regulatory reforms instituted by Congress and implemented by the Interstate Commerce Commission in the late 1970's and early 1980's was the express recognition that railroads must be permitted to cover their capital costs if a sound transportation system was to be preserved in this country.[6] The railroad industry is very capital-intensive. In 1998 alone, Class I railroads invested $7.2 billion, or 21.7 percent of their revenues, in plant and equipment. Over the past ten years, their capital expenditures have totaled $49 billion.[7]

The railroads' willingness to pour money back into the industry is largely attributable to the prospect that deregulation opened up for competitive financial returns in the industry. In the wake of Congress's passage of the Staggers Rail Act of 1980, the railroads abandoned a third of their track, reduced crew sizes, and used contracts to customize services and align their prices to the requirements of individual shippers. Aided by mergers, which were encouraged by the ICC and the Board, railroads streamlined their systems, diminished interchange costs, and made more effective use

[5] Keeler, Theodore E., *Railroads, Freight, and Public Policy* (1983), Brookings.

[6] 49 U.S.C. 10704(a)(2); *Standards for Railroad Revenue Adequacy*, 364 I.C.C. 803 (1981).

[7] Association of American Railroads, *Railroad Facts* (1999).

of their assets. Their real operating costs per ton-mile fell 60% between 1980 and 1998.[8] Rail traffic grew from a low of 19.5 million originating carloads in 1985 to 25.7 million in 1998.[9]

All of these factors helped boost the railroad's profitability. But the industry's financial improvement has not yet resulted in long-term accounting returns on investment at or near the levels calculated by the ICC and the Board as indicative of revenue adequacy for the industry. Railroads cannot simply raise rates to achieve greater profitability. Deregulation has unleashed cost reductions and productivity improvements for the railroads. At the same time, real rail rates to shippers have declined by half on average.[10] As shown in Exhibit 2 to this statement, in every year from 1978 through 1999, the industry's composite accounting return on investment has been less, and often substantially less, than its cost of capital as determined by the ICC and the Board. While the methods used by the Board and its predecessors to perform this calculation have been much debated, the figures in Exhibit 2 are so dramatic that it is unlikely,

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[8]Morrison, Steven A. and Clifford Winston, "Regulatory Reform of U.S. Intercity Transportation," in *Essays in Transportation, Economics and Policy: A Handbook in Honor of John H. Meyer,* edited by Jose Gomez-Ibanez, William B. Tye, and Clifford Winston (1999), Brookings.

[9] Association of American Railroads, *Railroad Facts* (1999).

[10] General Accounting Office, *Railroad Regulation: Changes in Railroad Rates and Service Quality Since 1990* (1999) (46% real rate reduction between 1982 and 1996); Association of American Railroads, *Railroad Facts* (1999) (57% real rate reduction between 1981 and 1998).

regardless of adjustments, that anyone could argue that the railroads' returns on investment have consistently exceeded their economic cost of capital.

The performance of railroad stocks indicates that railroads are having a difficult time earning their cost of capital. Exhibit 3 shows indexed monthly price change data for the Dow Jones Railroad Index–America plotted against the Standard & Poor's 500 Stock Index, an established proxy for the general market. From January 1995 onward, that railroad index substantially underperforms the S&P 500 and remains relatively stagnant over the period. When the comparison is made with the Standard & Poor's Railroad Index – which includes only the four largest railroads, BNSF, UP, Norfolk Southern, and CSX – the result is the same, as shown in Exhibit 4. Such a sustained period of stagnation during a raging bull market suggests considerable question in the investment community about the railroads' ability to cover the costs of their current systems over the long term. The last thing the Board should do under these circumstances is to enact ill-advised regulations that would reduce the railroads' long-term prospects for covering their capital costs.

Regulatory Risk and Railroad Investment Incentives. Limitations on a railroad's (or any other business's) use of its assets function as a tax. They reduce the assets' expected return by restricting the ways that the assets can be utilized. An investment that might otherwise have a positive net present value will not be undertaken if regulatory limitations so tax the expected stream of revenues that the value turns negative vis-a-vis the costs. The deterrent to investment is obvious when we know exactly what the regulatory limitations are, but the tax can be substantially compounded by delay and by an uncertain regulatory environment. When the amount of the regulatory tax cannot be established, railroads may choose not to make the investment at all. Alternatively, they may require a much higher return to cover the regulatory risk. Either way, the regulatory tax can kill an investment, or re-investment, that otherwise would have made good economic sense.[11]

Regulatory limitations on a railroad's use of its assets and uncertainty about future limitations act not only as disincentives for the railroads to invest in particular projects but also as disincentives for outside investors to invest in the railroad. Every year, railroads make large investments in track, rolling stock, and other related facilities to maintain their infrastructure and handle increased traffic. Many of these investments are fixed and sunk, and the assets involved have very long lives.[12] Investors have choices. If the long-term prospects of the rail industry are significantly clouded by regulatory restrictions and regulatory uncertainty, investors will be reluctant to risk their funds in the industry. This, in turn, may reduce the industry's access to funds in the capital markets and raises their cost of capital. This higher cost of capital translates into a reduced stock price, which hurts the firm's shareholders and further discourages new investment.

[11] I recognize that in some cases, the Board may choose to block a merger that increases shareholders' wealth if there is a greater cost to the public interest. This should be examined on a case-by-case basis.

[12] For a list of the types of long-lived assets involved, see 49 CFR Part 1201, Subpart A (Uniform System of Accounts).

The provisions of the Board's proposed rules indisputably serve to limit railroad companies' use of assets. If the Board uses the full 19-month period allowed,[13] it would significantly delay any proposed merger transaction between Class I railroads when compared with BNSF's proposed 12-month review period.[14] As BNSF has represented in its comments, mergers of major companies in other regulated industries can be accomplished in a matter of months.[15] A 19-month delay imposes a serious tax on the finances of any combination. In effect, it would set back by nearly two years the merging railroads' ability to begin to realize the benefits of the transaction. Moreover, it would make it impossible during that time period for either of the merging parties to determine their optimal capital expenditure levels and allocation of assets. Markets do not stand still while the Board is deliberating. The longer the Board takes, the longer the merging parties are caught in limbo. Investors and stockholders are well aware of the adverse effects this can have on profitability, and their perception of the risk will be reflected in both the value of the railroads' stock and in their decisions to invest in the industry.

The substantive criteria the Board proposes to use to assess Class I mergers also would impose a significant tax on the finances of proposed transactions. The justification the Board states for requiring merging parties to offer "competitive enhancements" is that

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[13] Proposed 49 CFR 1180.4(e)(2)-(3), NPR p. 27; 49 CFR 1180.4(b)(1) and (c)(7).

[14] BNSF in its Comments is proposing that the Board limit its merger review and decision time to one year, which would be a significant improvement from the standpoint of regulatory delay over a permitted 19-month schedule.

[15] BNSF Comments, Section III.A.

such enhancements are necessary to offset the presumed deleterious effects a merger will have on geographic and product competition and customer service.[16] But, as Professors Gómez-Ibáñez and Kalt explore in some detail in their verified statement on behalf of BNSF, the Board nowhere explains why those deleterious effects must be presumed or why conditions could not be fashioned that address any demonstrated deleterious effects directly. The result of setting up a hurdle of presumed but undefined and unquantified adverse merger effects, which must be overcome with unrelated "competitive enhancements," is that neither the railroads nor their investors can know with reasonable certainty what amount of "enhancements" will be required to overcome the presumed adverse effects. This makes it difficult to determine whether the transaction as planned will be approved or, if it is approved, whether the "enhancements" required will so diminish the benefits to the merging parties as to make the transaction uneconomic.

This uncertainty is compounded by proposals like those the Board makes, if it approves a merger, to closely monitor the public benefits that the merging railroads estimated would result from the merger and to seek "measures" to impose if those public benefits are not realized.[17] Merging railroads have every incentive to work to realize all of the benefits they have projected, and more, but railroads and their investors are acutely aware that they cannot control the markets for transportation services or the responses

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[16] Proposed 49 CFR 1180.1(c)-(d), NPR pp. 12-16.

[17] Proposed 49 CFR 1180.1(c)(1), NPR p. 14.

of the railroads' competitors. As it is currently worded, the Board's proposal provides a disincentive for railroads to contemplate combinations, even if they feel that they are the most profitable and efficient use of their assets, for fear of retributive behavior on the part of the Board. This possibility of retributive behavior acts as an uncertain tax upon the railroad companies' assets, which lowers the expected return to be earned on those assets. To threaten that undefined "measures" will be taken if the merging railroads fall short of their goals sets up another disincentive to merge at all. At the least, it requires that a further risk premium be assigned to the return that the railroads and their investors will require even to propose a merger transaction.

Similarly troubling from a financial standpoint is the proposed requirement that railroads anticipate possible responsive mergers, measure their benefits in light of those possible mergers, and discuss how conditions that may be imposed in their proposed merger would have to be altered, or new conditions imposed, if any future mergers were approved.[18] It would be hard enough to have to anticipate even in general terms what, if any, mergers might be proposed in reaction to a present merger proposal, without having to quantify the effects of the various possibilities on the benefits of the present proposal. The suggestion that the Board's approval of a future merger could result in new or altered conditions being imposed on a present merger further exacerbates the uncertainty for railroads and their investors in attempting to determine whether the

[18] Proposed 49 CFR 1180.1(i), NPR pp. 20-21.

present value of the flow of net revenues from the transaction will cover the capital costs.

Each of these regulatory taxes diminishes the prospective benefits of possible merger transactions. It is quite conceivable that a merger that otherwise promised to make the merging railroads more efficient, improve their services, and help them cover their cost of capital – with no unremedied competitive harms – would effectively be defeated by such taxes. That is not in the railroads' interest, it is not in their customers' interest, and it is not in the public interest.

Adverse Financial Effects of Burdensome Merger Regulation. The adverse effects of burdensome regulation are no secret in the rail industry. There is widespread agreement that much of the blame for the poor financial condition of the industry in the 1970's can be laid at the feet of overly restrictive regulation.[19] Investors cannot be compelled to invest their money in an industry that is constrained from covering its costs. When Congress passed the Staggers Act in 1980, it estimated that capital shortfall in the industry would grow to $16-20 billion by 1985 unless regulatory reforms were enacted.[20]

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[19] *See, e.g.,* General Accounting Office, *Railroad Regulation: Economic and Financial Impacts of the Staggers Rail Act of 1980* (1990), *Changes in Railroad Rates and Service Quality Since 1990* (1999); Braeutigam, R., "Consequences of Regulatory Reform in the American Railroad Industry," *Southern Econ. J.* 468 (Jan. 1993) ("Although regulatory reform has occurred in many American industries in the past two decades, in few of these industries was the need for reform as clear and urgent as in the domestic railroad industry during the 1970's").

[20] P.L. 96-448, Section 2(7).

As discussed earlier, the reforms that were enacted, including a policy that promoted efficient mergers, had the desired effect of reversing the railroads' decline and encouraging new investment in the industry. But the railroads' past improved performance cannot justify renewed investment in their overall systems unless it holds out the promise of enabling them to cover their overall costs.

Mergers, and the prospect of mergers, are one of the ways that the industry can justify reinvestment in systems that have not historically covered their cost of capital. If mergers provide the means to improve operating efficiency and build markets by offering new and improved rail services, then railroads may have reason to maintain and upgrade their systems in anticipation of future combinations that can meet the financial requirements of the market. If, on the other hand, the kinds of regulatory taxes contained in the Board's proposed merger rules overly burden mergers that make good economic and competitive sense, then those mergers either will not happen, or their benefits will be significantly reduced. The predictable result will be a reduced expected return for the railroads' assets, a reduction in capital spending, a higher cost of capital, harm to shareholders, and, ultimately, harm to shippers if the services they want cannot be supported.

Charles
River
Associates

BRADFORD CORNELL — *Professor of Financial Economics,*
Anderson Graduate School of Management, UCLA

Ph.D.	Financial Economics, Stanford University, 1975
M.S.	Statistics, Stanford University, 1974
A.B.	(Interdepartmental) Physics, Philosophy and Psychology, Stanford University, 1970

ACADEMIC AND PROFESSIONAL POSITIONS

1987-Present:	Professor of Finance and Director of the Bank of America Research Center, Anderson Graduate School of Management, UCLA
1990-1999:	President, FinEcon: Financial Economic Consulting
1988-1990:	Vice-President and Director of the Securities Litigation Group, Economic Analysis Corporation
1979-1986:	Assistant and Associate Professor of Finance, UCLA
1983-1984:	Visiting Professor of Finance, California Institute of Technology
1977-1979:	Assistant Professor of Finance, University of Southern California
1975-1977:	Assistant Professor of Finance, University of Arizona

Courses Taught

Corporate Valuation
The Law and Finance of Corporate Acquisitions and Restructurings
Corporate Financial Theory
The Theory of Finance (in the UCLA Law School)
Security Valuation and Investments
A wide variety of executive and community education programs

Special Education Programs Include

The U.S. Business School in Prague — Special Finance Program, Summer 1991
The Nissan Program for Historically Black Colleges, Director, Summer 1989

The Lead Program for Business Education of Minority High School Students, 1987-Present

CONSULTING AND PROFESSIONAL ACTIVITIES

Selected Service at UCLA

Twice Chairman of Finance Department
Twice Vice Chairman of the Anderson School
Three-time member of the staffing and promotion committee

Service to Scholarly Journals and Organizations

Served as an associate editor for a variety of scholarly and business journals including: *Journal of Finance*, *Journal of International Business Studies*, *Journal of Business and Economics*, *Journal of Financial Research*, *Journal of Futures Markets*, and the *Investment Management Review*.

Served as a reviewer for numerous finance and economics journals including: *American Economic Review*, *Journal of Political Economy*, *Journal of Financial Economics*, *Journal of Business*, *Journal of Financial and Quantitative Analysis*, and the *Review of Economics and Statistics*.

Memberships in Professional Societies

American Finance Association: 1973-Present
Member of Board of Directors: 1987-1989
Western Finance Association: 1973-Present
Member of Board of Directors: 1982-1985
Vice President: 1987
American Economic Association: 1973-Present
American Bar Association: 1995-Present
American Statistical Association: 1992-Present
International Association of Financial Engineers: 1993-Present
American Law and Economics Association: 1995-Present
Human Behavior and Evolution Society: 1995-Present

Research Evaluation

Project reviewer for the National Science Foundation: 1979-Present
Program committee for the Western Finance Association: 1982-1988

Selected Board and Committee Memberships

Chairman, Mayor Riordan's Blue Ribbon Commission on Los Angeles' Municipal Investments
Pension Policy Board, The Aerospace Corporation: 1985-Present
Forms Engineering Corporation: 1976-1997
Trustee, Kellow Trust: 1982-1991

Selected Consulting Clients

Merrill Lynch (obtained futures broker's license, owned a seat on the International Monetary Market of the Chicago Mercantile Exchange)
Chase Manhattan Bank
Thrifty Corporation
Wynn Oil
Resorts International

Expert Witness

Numerous cases involving the application of financial economics

Media Experience

Occasional contributor to *The Wall Street Journal* and *The Los Angeles Times*
Occasional commentator for local television and radio stations
Lecturer on valuation theory, appraisal practice, and securities pricing

PUBLICATIONS

Books

Cornell, B., 1999, *The Equity Risk Premium and the Long-run Future of the Stock Market*, John Wiley and Sons, New York, NY.

Cornell, B., 1994, "Corporate Valuation," in *Handbook of Modern Finance*, 3rd edition, Dennis Logue, ed., Warren Gorham Lamont, Boston, MA.

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Cornell, B., W. Landsman and A. Shapiro, 1989, "Cross Sectional Regularities in the Reaction of Stock Prices to Bond Rating Changes," *Journal of Accounting, Auditing and Finance*, 4 (No. 4): 460-479.

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Cornell, B., 1996, *Social Decoding and Ethnic Discrimination*, book length manuscript.

Cornell, B. and S.C. Cheng, 1995, "Using the DCF Method to Estimate the Cross-Sectional Variation of Expected Returns."

Cornell, B., 1984, "Testing the Tax Timing Option Theory: A New Approach."

Cornell, B. and J.K. Dietrich, 1979, "Determinants of Corporate Capital Structure: An Empirical Analysis."

AWARDS AND HONORS

Cited as one of the ten most prolific research authors in the field of finance, in "Most Frequent Contributors to the Finance Literature," by Jean Louis Heck and Phillip L. Cooley, *Financial Management*, Autumn, 1980.

Financial Management Association Prize for Applied Research: 1987

Institute for Quantitative Research in Finance, Research Grant: 1984

Center for the Study of Futures Markets, Research Grant: 1983

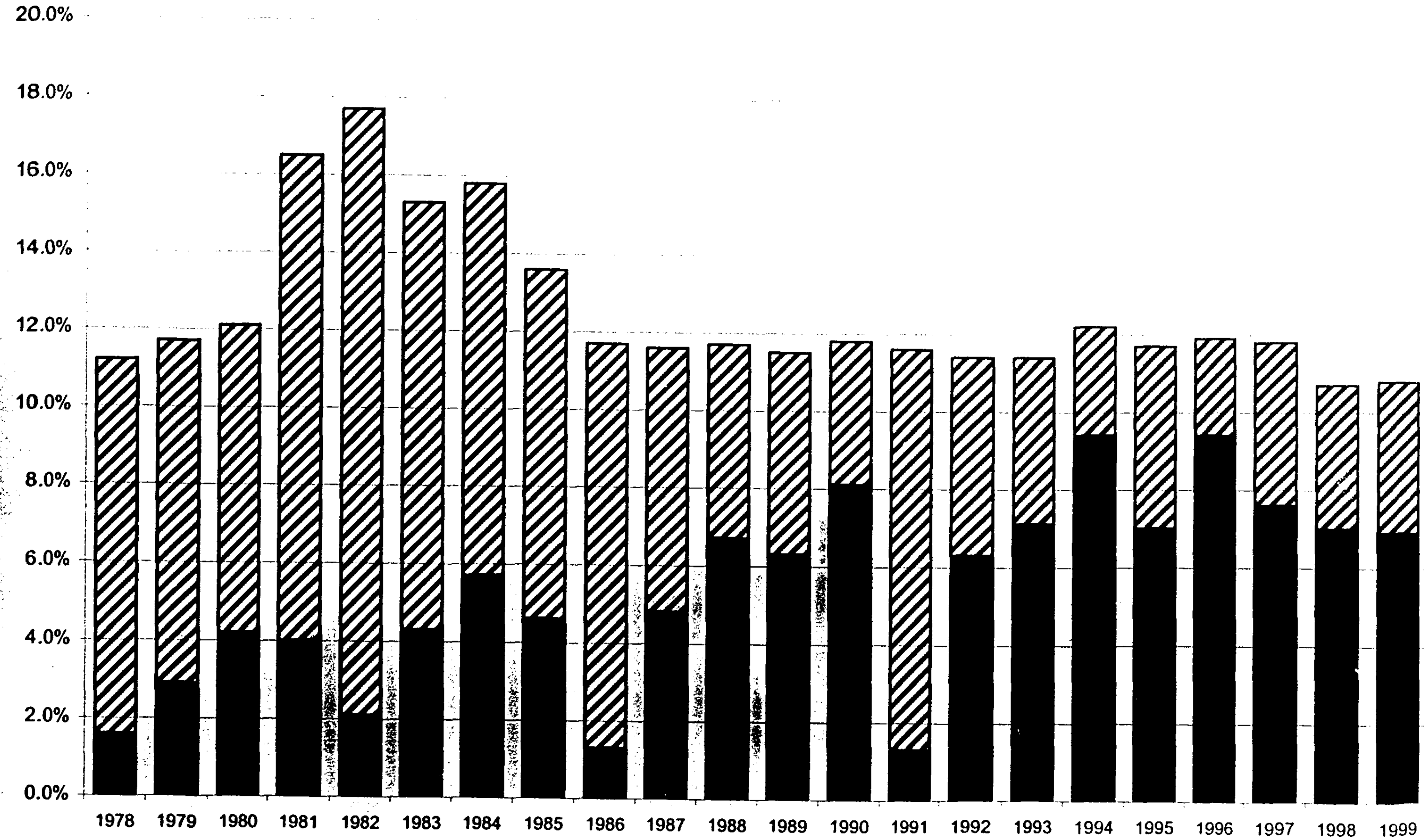
Center for the Study of Futures Markets, Research Grant: 1981

Chicago Mercantile Exchange, Research Grant: 1979

Phi Beta Kappa, Stanford University, 1970

Graduated with distinction, Stanford University, 1970

Exhibit 2
Accounting Return on Investment and STB-Determined Cost of Capital Shortfall
1978 - 1999



Source: ICC/STB published Revenue Adequacy Decisions, AAR Ten Year Trends

Exhibit 3
Indexed Price Performance
Dow Jones American Railroad Index and S&P 500 Index
12/31/94 - 10/30/2000

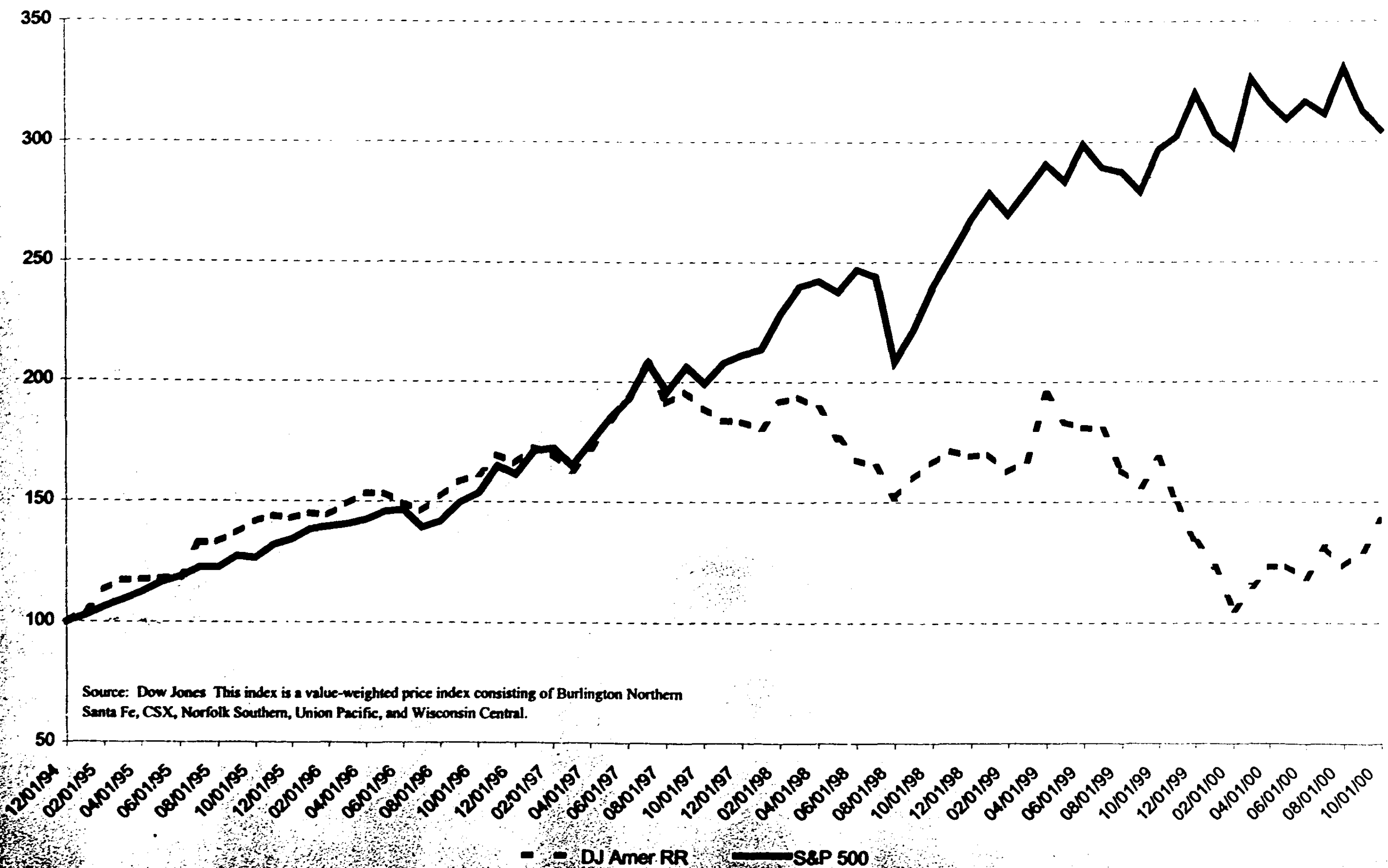
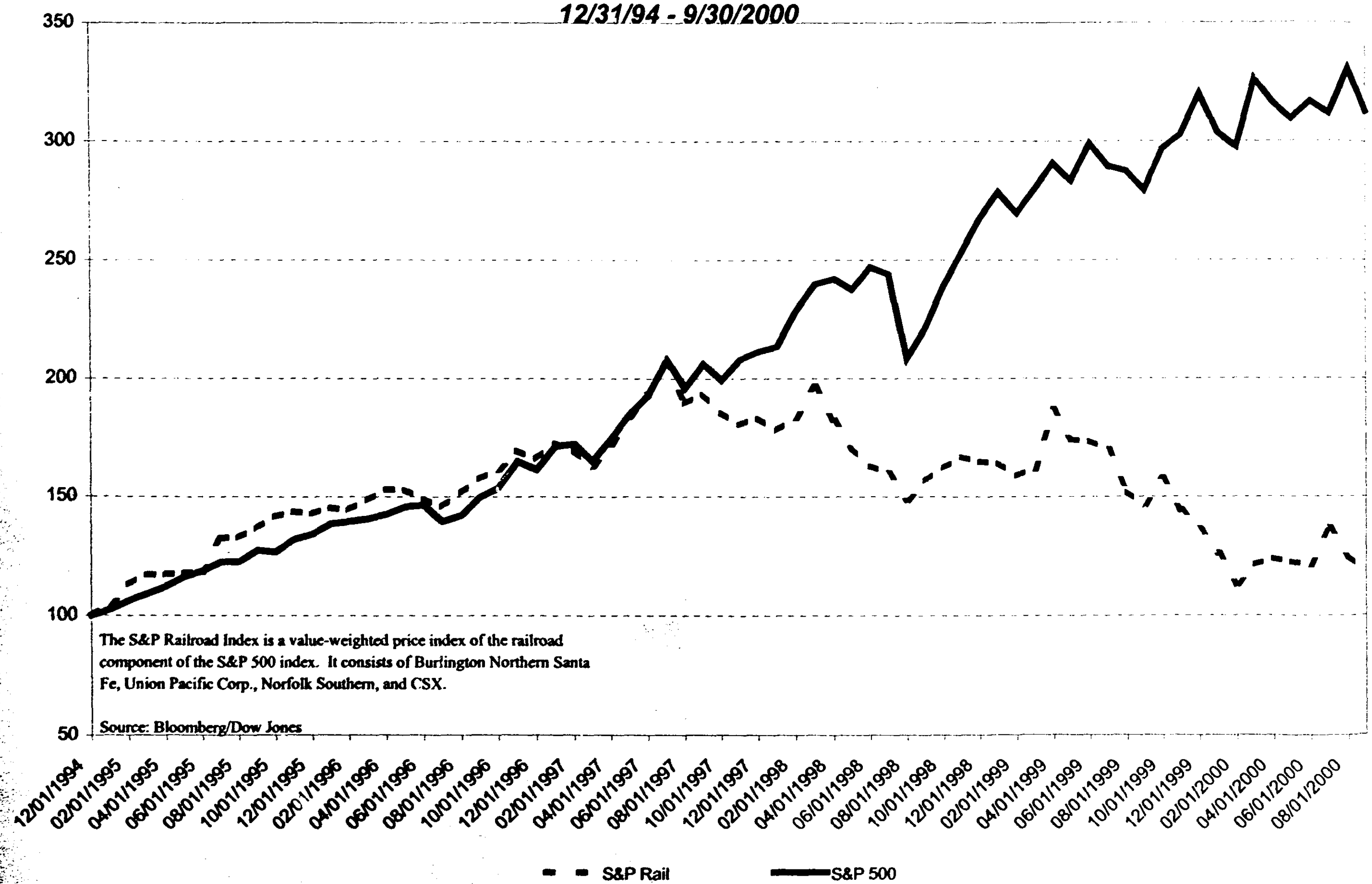


Exhibit 4
Indexed Price Performance
S&P Railroad and 500 Indices
12/31/94 - 9/30/2000



VERIFICATION

I, Bradford Cornell, verify under penalty of perjury under the laws of the United States that the foregoing is true and correct. Further, I certify that I am qualified and authorized to file this Verified Statement.

Executed on November 16, 2000.

Bradford Cornell

Bradford Cornell